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No. OFFICE OF THE CLERK

In The

Supreme Court of the United States

October Term, 1996

TIMOTHY J. ANDERSON, NEIL SINGER and ARTHUR SINGER, On Behalf of Themselves and All Others Similarly Situated,

Petitioners,

vs.

GARY W. CLOW, DOUGLAS L. WHITING, ROBERT W. JOHNSON, ARTHUR J. COLLMEYER, JOHN R. WITZIL, STAC ELECTRONICS, INC., ALEX. BROWN & SONS, INC., and MONTGOMERY SECURITIES,

Respondents.

On Petition For Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

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I. QUESTIONS PRESENTED

1. Whether Federal Rule of Civil Procedure 9(b), which requires claims for fraud or mistake to be pleaded with particularity, can be applied to claims under Section 11 of the Securities Act of 1993, which creates a strict-liability cause of action.

2. Whether, under Federal Rule of Civil Procedure 8(e)(2)'s provision allowing pleading in the alternative, and this Court's holding that remedies under the securities acts are cumulative, plaintiffs may plead a strict-liability claim under Securities Act §11 and a fraud claim under Securities Exchange Act §10(b) in the same complaint, without subjecting the strict-liability §11 claim to heightened requirements for pleading fraud.

3. Whether persons who sell securities with false financial statements that use inadequate reserves to overstate earnings are entitled to avoid liability, as a matter of law under the "bespeaks caution doctrine," by including a boilerplate statement that "there can be no assurance" the reserves will prove adequate.

II. PARTIES TO THE PROCEEDING

Appellants before the Court of Appeals were plaintiffs Timothy J. Anderson, Neil Singer, and Arthur Singer, on behalf of themselves and all others similarly situated. The Appellees were defendants Stac Electronics, Inc., and certain of its officers and directors, Gary W. Clow, Douglas L. Whiting, Robert W. Johnson, Arthur J. Collmeyer, John R. Witzil, Robert A. Hoff, Lawrence G. Finch, and Russell J. Robelen, as well as venture capitalists Crosspoint Venture Partners, Sigma Management, Sigma Management II, L.P., Sigma Partners, Idanta Partners, and Stac's underwriters, Alex. Brown & Sons, Inc., and Montgomery Securities.

Defendants Sigma Management, Sigma Management II, L.P., Crosspoint Venture Partners, Richard A. Hoff, Russell J. Robelen, Lawrence Finch, and Idanta Partners ceased to be parties to the appeal when claims against them were voluntarily dismissed by stipulation. 156a, 157a.

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V. OPINIONS BELOW

The opinion below is published as *In re Stac Elec. Sec. Litig.*, 89 F.3d 1399 (9th Cir. 1996), and printed in the Appendix at 1a-29a. This opinion withdraws an earlier opinion published at 82 F.3d 1480 (9th Cir. 1996), 30a-56a. It affirms the district court opinion reported as *Anderson v. Clow*, [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶98,367 (S.D. Cal. June 29, 1994), 58a-111a, which dismissed the case with prejudice. An earlier district court opinion, dismissing a previous complaint with leave to amend, is reported as *Anderson v. Clow*, [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶97,807 (S.D. Cal. Sept. 17, 1993), 113a-153a.

VI. BASIS FOR JURISDICTION IN THIS COURT

The Ninth Circuit initially entered judgment on May 7, 1996. 30a. After plaintiffs filed a petition for rehearing, the Court withdrew its opinion and entered judgment with a new opinion on July 17, 1996. 1a. Plaintiffs' timely petition for rehearing was denied on August 27, 1996. 154a-155a. This Court has jurisdiction under 28 U.S.C. §§1254, 2101(c), and Supreme Court Rule 13.

VII. STATUTES AND RULES

The statutes and rules involved in this case appear in the Appendix. 158a, *et seq.*

VIII. STATEMENT OF THE CASE

A. Introduction

Plaintiffs filed this action on behalf of a class of investors who purchased registered common stock of Stac Electronics, Inc. ("Stac" or the "Company") in, or shortly after, Stac's May 7, 1992 initial public offering.

Stac went public at $12 per share, taking $36 million from investors for itself and certain insiders by means of a prospectus that allegedly overstated the Company's earnings in violation of Generally Accepted Accounting Principles ("GAAP"). 172a-176a, 179a-181a, 201a-202a, 209a-217a, 241a-242a. Five of the Company's highest executive officers sold their own shares, taking more than $6.4 million. 185a-186a, 206a, 240a-241a. Less than 90 days later, Stac reported disappointing results and its stock plunged first to $5.50 per share and shortly thereafter to $3.00 per share. 182a, 236a. Stac and its insiders made millions, while public investors lost most of the money they invested.

Plaintiffs, who had invested in Stac, filed this class action alleging that Stac's prospectus was false and misleading for several reasons, most significantly because the financial statements in the prospectus included an inadequate reserve for product returns and thus overstated the Company's earnings.[1] The prospectus also

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[1] A reserve for returns is a deduction from assets and earnings to reflect the fact that some shipped products would be returned for refund or credit. *See* 241a-242a. Understated reserves result in overstated earnings. *See In re Wells Fargo Sec. Litig.*, 12 F.3d 922, 926 (9th Cir. 1993), *cert. denied*, ___ U.S. ___,

falsely attributed Stac's recent favorable financial results, including its highly profitable March 31, 1992 quarter, "to increased demand for Stacker products," when defendants knew demand had fallen and that the favorable results were due to the failure t take adequate reserves for returns. 211a-214a. In fact, defendants knew that Stac's "sales" had been accomplished only by offering special discounts and rights of return – in essence selling the goods on consignment, which would inevitably result in huge returns. 212a-213a.

A company that "substantially overstates its revenues by reporting consignment transactions as sales . . . mak[es] false or misleading statements of material fact," *Malone v. Microdyne Corp.*, 26 F.3d 471, 478 (4th Cir. 1994), and Stac could not recognize revenues on "sales" with a right of return unless it could make a reasonable estimate of – and take reserves for – product returns. *See* Financial Accounting Standards Board's Statement of Financial Accounting Standards ("FAS") 48; *Marksman Partners, L.P. v. Chantal Pharm. Corp.*, 927 F. Supp. 1297, 1301 & n.1, 1304-05, 1315 (C.D. Cal. 1996). Nonetheless, the Company did *not* increase its reserve for returns to reflect the special terms it had offered distributors. Instead, Stac established inadequate reserves in order to be able to report high earnings, telling investors in the prospectus that "[a]lthough the Company *believes that it provides adequate allowances* for returns, *there can be no assurance* that actual returns in excess of recorded allowances will not result in a material adverse effect on

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115 S.Ct. 295 (1994); *Blackie v. Barrack*, 524 F.2d 891, 904 (9th Cir. 1975).

the Company's business, operating results or financial condition."[2]

Plaintiffs pleaded separate counts under Securities Act of 1933 ("Securities Act") §11, which does not require proof of fraud, and Securities Exchange Act of 1934 ("Exchange Act") §10(b), which does. ER 45:¶¶76-79 (§11 count), 83-93 (§10(b) count). When a registration statement is false or misleading, the issuer is strictly liable under §11, and others involved in the offering can avoid liability only by carrying an affirmative defense of providing "due diligence." *See* 15 U.S.C. §77k; *Herman & MacLean v. Huddleston*, 459 U.S. 375, 382 (1983). The count for relief under §11 expressly disclaimed reliance on any allegations of fraud contained in plaintiffs' §10(b) claims. 243a.

Because Congress provided that plaintiffs' *prima facie* case under §11 should require no proof of fraud, courts routinely have held that such claims are not subject to Federal Rule of Civil Procedure 9(b)'s requirement that allegations of fraud must be made with particularity. In this case, however, the Ninth Circuit held that plaintiffs' §11 claims could be dismissed under Rule 9(b)'s particularity requirement because they "sound in fraud." 11a-12a. It therefore affirmed dismissal of plaintiffs' §11 claims for failure to comply with Rule 9(b). The Ninth Circuit also held that Stac's allegedly false financial statements were inactionable as a matter of law because the prospectus warned "there can be no assurance" the stated reserves would be adequate. 21a-22a.

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[2] 214a-215a. Emphasis is added unless otherwise noted.

B. Statement Of The Facts Alleged

As alleged in the Second Amended Complaint, Stac's primary product and main source of revenue in 1991 was the Stacker, a computer-software product that compresses data and thereby increases the capacity of a computer's operating system. 167a-168a. Sales were initially brisk, and Stac enjoyed significant revenue and earnings growth through 1991. *Id.*

Stac appeared to have a lock-hold on an expanding market for a product that only Stac could supply, 169a, and planned to take advantage of this by going public in 1992. By late 1991, however, Stac knew it faced a threat of competition from similar products, and learned that industry giant Microsoft, Inc. ("Microsoft") planned to include its own data-compression capability in the next version of its MS-DOS operating system.[3]

So that the most recent financial results in Stac's prospectus would look strong, Stac reported inflated revenues and earnings for its second fiscal quarter, ending March 31, 1992. The Company did so by offering its

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[3] 169a. From negotiations with Microsoft, Stac's top executives *knew* that Microsoft would incorporate this technology soon, 198a-199a, but the prospectus failed to mention the negotiations presenting only a generic "warning" that:

> *There can be no assurance* that Microsoft or personal computer manufacturers will not incorporate a competitive data compression technology in their products or that such a technology will not otherwise emerge as an industry standard.

220a.

distributors special terms – including special discounts and unlimited or expanded rights of return – to induce the purchase of abnormal quantities of Stacker prior to March 31, 1992. 172a-173a, 201a. Thus, at no risk to the distributors, and by improperly recognizing revenue on what in essence were contingent sales, Stac managed to increase its apparent sales when, in truth, actual sales to end users were declining. Stac then reported misleading quarterly sales in its prospectus, suggesting continuing strong demand for its products. 174a-175a, 201a, 209a-214a.

Stac understated required reserves for returns, thus materially overstating its net income and earnings per share for the second quarter. 241a-242a. The heavy discounts and other inducements allowed Stac to *borrow* revenue from future periods and virtually guaranteed that Stac's financial results for subsequent quarters would decline materially when demand fell off and unsold product was returned. 172a-173a, 179a, 201a. Although Stac knew that many of the so-called "sales" it reported would be voided after March 31, 1992, when distributors returned the product, it would not take a charge against its earnings for those returns until *after the offering*. 236a.

As a result, Stac's reported second quarter financial results were materially false and misleading and violated GAAP, because the Company established grossly understated reserves – and reported correspondingly overstated earnings – in violation of FAS 48, paragraph 7. *See* 172a-176a, 179a-181a, 201a-202a, 209a-217a, 241a-242a.

Far from disclosing these practices, the prospectus dissembled about them:

> The Company sells substantially all of its products based on an established discount structure, *which has not varied significantly from quarter to quarter. The Company does not believe that its discounting activities have significantly affected revenues or results of operations in any given period.*

211a. Further, with no reasonable basis for believing reserves were adequate, the prospectus nevertheless told investors:

> Although *the Company believes it provides adequate allowances* for returns, *there can be no assurance* that actual returns in excess of recorded allowances will not result in a material adverse effect on the Company's business, operating results or financial condition.

214a-215a. The prospectus falsely characterized Stac's purported "increase" in second quarter revenues as the result of increasing demand for its products, based on "awards and reviews published in that quarter." 211a.

By misleading the public, Stac and its insiders were able to sell 3 million shares of its stock at $12 per share – for proceeds of $36 million. 179a-180a. Less than 90 days later, however, Stac reported that third quarter sales of Stacker had *fallen* from the second quarter. 236a. Net income was down, 236a, and the reason given for this decline – *for the very quarter in which Stac went public* – was an increase in inventory writedowns on returned product that had previously been falsely reported as "sales". 236a. The reserves for returns in fact had been grossly inadequate.

The market reacted swiftly to the news and Stac's stock price plummeted from a high of $15-3/4 to just

$5-1/2, and continued to decline to just $3 per share by September 1992. 182a, 236a. Thereafter, Stac's business continued to decline, due to declining sales of Stacker, and its stock price ultimately fell to as low as $1-3/4 per share. 182a, 236a. Stac and its insiders had made millions from the public offering by using misleading financial statements to sell to public investors stock that would quickly lose most of its value.

C. Rulings Of The Courts Below And The Bases For Their Jurisdiction

On the basis of these facts, plaintiffs on July 23 and 24, 1992, filed separate Class Action Complaints alleging violations of federal securities laws. The cases were consolidated, and plaintiffs filed a Consolidated Amended Class Action Complaint For Violation Of The Federal Securities Laws (the "First Amended Complaint") on December 4, 1992, which stated separate counts under Securities Act §11, which does not require a showing of fraud, and Exchange Act §10(b), which does. The district court had jurisdiction under 15 U.S.C. §§77v and 78aa, and 28 U.S.C. §1331, but it dismissed plaintiffs' First Amended Complaint on September 30, 1993, applying the heightened fraud pleading standards of Federal Rule of Civil Procedure 9(b) to plaintiffs' §11 claim. 113a-153a.

The Second Amended Complaint For Violation Of The Federal Securities Laws ("Complaint"), which is the operative complaint for purposes of this appeal, set forth in greater detail the prospectus' misrepresentations and

omissions, again pleading §10(b) and §11 claims in separate counts. ER 45. Nonetheless, the district court dismissed this Complaint *with prejudice* for failing to plead fraud with particularity under Rule 9(b) and for failure to state a claim under Rule 12(b)(6), 58a-111a, and entered judgment on July 11, 1994. 57a. Plaintiffs timely filed their Notice of Appeal on August 1, 1994.

A panel of the Ninth Circuit, which had jurisdiction under 28 U.S.C. §1291, initially affirmed in an opinion filed May 7, 1996. *In re Stac Elec. Sec. Litig.*, 82 F.3d 1480 (9th Cir. 1996). 30a-56a. After plaintiffs petitioned for rehearing and suggested rehearing en banc, the panel withdrew its May 7, 1996 opinion and issued a new opinion filed July 17, 1996. 1a-29a. The new opinion changed the court's analysis on several issues, but reached the same result. 29a.

The Ninth Circuit held that plaintiffs' §11 claims could be dismissed under Rule 9(b)'s heightened pleading requirements because they "sound in fraud." 10a-12a. According to the Ninth Circuit, the same "policy considerations" supported application of Rule 9(b) to plaintiffs' §11 claims as to their §10(b) claims, which require proof of fraud. 12a. The court also held that the false financial statements in this case could not be actionable because they were accompanied by cautionary statements warning there was "no assurance" that reserves would prove adequate. 12a.

Plaintiffs timely petitioned for rehearing, but the Ninth Circuit denied the petition on August 27, 1996. 154a-155a.

IX. REASONS FOR GRANTING THE WRIT

The opinion below warrants this Court's review to resolve important questions on which the lower courts are in conflict.

The first is whether Rule 9(b)'s requirement that circumstances constituting fraud must be averred with particularity can be applied to dismiss *nonfraud claims* arising under Securities Act §11. *Leatherman v. Tarrant County Narcotics Intelligence & Coordination Unit*, 507 U.S. 163, 167-68 (1993), flatly prohibits application of heightened pleading requirements to non-fraud claims, *id.*, and §11 creates a strict-liability cause of action that does not require plaintiffs to plead or prove fraud, mistake, or even negligence. *See infra*. Many lower court decisions accordingly hold that Rule 9(b)'s heightened particularity requirement for allegations of fraud cannot be applied to §11 claims.[4]

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[4] *See In re In-Store Advertising Sec. Litig.*, 878 F. Supp. 645, 650 (S.D.N.Y. 1995); *In re AnnTaylor Stores Sec. Litig.*, 807 F. Supp. 990, 1003 (S.D.N.Y. 1992); *In re Lilco Sec. Litig.*, 625 F. Supp. 1500, 1502 (E.D.N.Y. 1986); *Seidel v. Public Serv. Co.*, 616 F. Supp. 1342, 1356-57 (D.N.H. 1985); *see also In re Jiffy Lube Sec. Litig.*, 772 F. Supp. 258, 260 (D. Md. 1991); *Schneider v. Traweek*, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶95,507, at 97,662 (C.D. Cal. September 5, 1990); *Steiner v. Southmark Corp.*, 734 F. Supp. 269, 278 (N.D. Tex. 1990); *Ross v. Warner*, 480 F. Supp. 268, 273 (S.D.N.Y. 1979); *Husted v. Amrep Corp.*, 429 F. Supp. 298, 310 (S.D.N.Y. 1977); *Billet v. Storage Technology Corp.*, 72 F.R.D. 583, 585 (S.D.N.Y. 1976); *Schoenfeld v. Giant Stores Corp.*, 62 F.R.D. 348, 350-51 (S.D.N.Y. 1974).

But the precedents are in disarray, for other courts have applied Rule 9(b)'s heightened particularity requirement to §11 claims on the ground that they "sound in fraud."[5] In response to this confusion, some securities plaintiffs have resorted to filing multiple actions – with the complaint in one case alleging §10(b) violations and yet another complaint, seeking relief under §11 – to ensure that the pleading standards for §10(b) claims are not applied to the §11 claims. *See Shaw v. Digital Equipment Corp.*, 82 F.3d 1194, 1201, 1222-23 (1st Cir. 1996) (apparently endorsing this practice).

The Ninth Circuit, in this case, has added to the confusion by joining the courts that apply Rule 9(b) to strict-liability §11 claims on the ground that they "sound in fraud" when joined with allegations of fraud under §10(b). The court reasoned that the same "policy considerations" that apply to §10(b) fraud claims also require dismissal of plaintiffs' §11 claims – even though plaintiffs carefully pleaded §10(b) and §11 claims in separate counts, *and specifically disclaimed reliance on allegations of fraud* for the §11 claim. 11a-12a, 243a.

Rule 8, of course, provides for claims to be pleaded in the alternative, and commands that insufficiency of one theory (*e.g.*, fraud) cannot be used to dismiss a claim that

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[5] *See, e.g., Melder v. Morris*, 27 F.3d 1097, 1100 n.6 (5th Cir. 1994); *Shapiro v. UJB Fin. Corp.*, 964 F.2d 272, 287-89 (3d Cir. 1996); *Degulis v. LXR Biotechnology, Inc.*, 928 F. Supp. 1301, 1310 (S.D.N.Y. 1996).

might survive under another theory (such as strict liability or negligence). Fed. R. Civ. P. 8(a), 8(e)(2). Moreover, in *Herman & MacLean v. Huddleston*, 459 U.S. 375 (1983), this Court held that remedies under the securities statutes are cumulative, and that availability or limitations on relief under one section *cannot be used to deny relief under another section*. Nonetheless, the Ninth Circuit held that plaintiffs' §11 claim "sounds in fraud" and is subject to dismissal under Rule 9(b) as if it were a §10(b) claim.

Review by this Court thus is necessary to correct the confusion among the lower courts regarding application of Rule 9(b) to strict-liability claims under §11. The fact that the First, Third, Fifth and Ninth Circuits have formally endorsed application of Rule 9(b) to §11 claims that they say "sound in fraud," *see supra* note 6, while many others have held that Rule 9(b) cannot apply to such claims, demonstrates that *only* review by this Court can restore sense and coherence to the law in this area.

In addition, this case presents the question of whether a boilerplate disclaimer – that "there can be no assurance" that reserves will be adequate – immunizes defendants from liability for overstating historical earnings by understating reserves. Many decisions hold that false statements about reserves are actionable.[6] The Seventh Circuit has held, in *United States v. Morris*, 80 F.3d

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[6] *E.g., In re GlenFed, Inc. Sec. Litig.*, 42 F.3d 1541, 1550-51 (9th Cir. 1994) (en banc); *In re Wells Fargo Sec. Litig.*, 12 F.3d 922, 926-28 (9th Cir. 1993); *Hayes v. Gross*, 982 F.2d 104, 106-07 (3d Cir. 1992); *Shapiro v. UJB Financial Corp.*, 964 F.2d 272, 283 (3d Cir. 1992); *Blackie v. Barrack*, 524 F.2d 891, 904 (9th Cir. 1975).

1151, 1166-68 (7th Cir. 1996) that a "no assurance" disclaimer is ineffective, and other decisions have similarly held that generic "no assurance" disclaimers do not render misleading statements inactionable as a matter of law.[7] Still other circuit-court decisions have held that "no assurance" disclaimers can, as a matter of law, eliminate potential liability for misrepresentations.[8]

The nature and scope of the "bespeaks caution doctrine" and the effectiveness of such disclaimers is very important to securities litigation. It has engendered considerable controversy, and the lower courts have imposed utterly irreconcilable rules of law regarding "no assurance" disclaimers. Again, this Court's attention is warranted, to resolve confusion in the lower courts on a very important question of law.

A. This Court Should Resolve Conflict Among The Lower Courts On Application Of Rule 9(b) To Strict-Liability §11 Claims

The lower courts are in disarray on whether Rule 9(b), which limits its particularity requirement to "averments of fraud or mistake," can be applied to dismiss

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[7] *See, e.g., Harden v. Raffensperger, Hughes & Co.*, 65 F.3d 1392, 1404-06 (7th Cir. 1995); *Rubinstein v. Collins*, 20 F.3d 160, 163-64, 166-68 (5th Cir. 1994).

[8] *See, e.g., Olkey v. Hyperion 1999 Term Trust, Inc.*, No. 95-7823, 1996 U.S. App. LEXIS 26784, at *23 (2d Cir. Oct. 15, 1996); *Glassman v. Computervision Corp.*, 90 F.3d 617, 633-34 & n.27 (1st Cir. 1996); *Romani v. Shearson Lehman Hutton*, 929 F.2d 875, 879 (1st Cir. 1991); *Luce v. Edelstein*, 802 F.2d 49, 56 (2d Cir. 1986).

strict-liability §11 claims. The opinion below holds that "policy considerations" justify the application of Rule 9(b) to the §11 claims in this case, which do not allege fraud or mistake. 12a.

In *Leatherman*, however, this Court held that "policy considerations" cannot justify application of heightened pleading requirements beyond the precise scope of Rule 9(b)'s text. 507 U.S. at 168. Indeed, *Leatherman* reversed the Fifth Circuit for relying on policy considerations to apply a heightened pleading standard to a civil rights action against a municipality. *Id.* Chief Justice Rehnquist's opinion for the Court explained:

> Rule 9(b) does impose a particularity requirement *in two specific instances*. It provides that "in all averments of *fraud or mistake*, the circumstances constituting fraud or mistake shall be stated with particularity." Thus, the Federal Rules do address in Rule 9(b) the question of the need for greater particularity in pleading certain actions, but do not include among the enumerated actions any reference to complaints alleging municipal liability under §1983. *Expressio unius est exclusio alterius.*

507 U.S. at 168.

Claims under §11 simply are not claims for fraud or mistake within the scope of Rule 9(b). With §11 and §12 of the Securities Act, Congress took care to impose "liability *without proof of* either *fraud* or reliance on 'those whose moral responsibility to the public is particularly heavy' – the 'originators of securities.' " *Gustafson v. Alloyd Co.*, ___ U.S. ___, 115 S. Ct. 1061, 1073 (1995) (quoting H.R. Rep.

No. 85, 73rd Cong., 1st Sess. 5 (1933)); *see Huddleston*, 459 U.S. at 382. Section 11 "imposes *a form of strict liability* for material misstatements or omissions of fact in registration statements." *Greenapple v. Detroit Edison Co.*, 618 F.2d 198, 203 (2d Cir. 1980); *accord, e.g., Harden v. Raffensperger, Hughes & Co.*, 933 F. Supp. 763, 770 (S.D. Ind. 1996). It places on plaintiffs no burden of pleading or proving fraud, mistake, or even negligence.

"If a plaintiff purchased a security issued pursuant to a registration statement, he need only show a material misstatement or omission to establish his prima facie case." *Huddleston*, 459 U.S. at 382. "Within the limits specified by §11(e), the issuer of the securities is held *absolutely liable* for any damages resulting from such misstatement or omission." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 208 (1976). "Liability against the issuer of a security is virtually absolute, even for innocent misstatements." *Huddleston*, 459 U.S. at 382 (footnote omitted). "Other defendants bear the burden of demonstrating due diligence." *Id.*

Because claims under §11 are not claims for fraud or mistake, most courts, consistent with *Leatherman*, hold that Rule 9(b) cannot apply to them.[9] Several courts have

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[9] *See In re In-Store Advertising Sec. Litig.*, 878 F. Supp. 645, 650 (S.D.N.Y. 1995); *In re AnnTaylor Stores Sec. Litig.*, 807 F. Supp. 990, 1003 (S.D.N.Y. 1992); *In re Lilco Sec. Litig.*, 625 F. Supp. 1500, 1502 (E.D.N.Y. 1986); *Seidel v. Public Serv. Co.*, 616 F. Supp. 1342, 1356-57 (D.N.H. 1985); *see also In re Jiffy Lube Sec. Litig.*, 772 F. Supp. 258, 260 (D. Md. 1991); *Schneider v. Traweek*, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶95,507, at 97,662 (C.D. Cal. September 5, 1990); *Steiner v. Southmark Corp.*, 734 F. Supp. 269, 278 (N.D. Tex. 1990); *Ross v. Warner*, 480 F. Supp. 268, 273

nonetheless held, as the Ninth Circuit did below, that §11 and §12 claims "sound in fraud" – making them subject to Rule 9(b)'s heightened pleading requirements.[10]

The lower courts are in conflict and the Ninth Circuit has joined several other circuits in adopting a rule that is at odds with this Court's holding in *Leatherman*. Only review by this Court will resolve this conflict among the lower court decisions. Review should be granted to further uniform application of Rule 9(b), and to make clear to reluctant lower courts that this Court meant what it said in *Leatherman*.

B. The Conflict Among The Lower Courts On Application Of Rule 9(b) To §11 Claims Affects The Sensible Administration Of Justice And Impairs Enforcement Of The Securities Laws

Conflict among the lower courts on application of Rule 9(b) to strict-liability §11 claims has serious consequences, both for efficient administration of justice by the federal courts and for effective enforcement of the securities laws. Circuit-court decisions that apply Rule 9(b) pleading requirements to §11 strict-liability claims when they are joined with §10(b) fraud claims in the same

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(S.D.N.Y. 1979); *Husted v. Amrep Corp.*, 429 F. Supp. 298, 310 (S.D.N.Y. 1977); *Billet v. Storage Technology Corp.*, 72 F.R.D. 583, 585 (S.D.N.Y. 1976); *Schoenfeld v. Giant Stores Corp.*, 62 F.R.D. 348, 350-51 (S.D.N.Y. 1974).

[10] *See, e.g., Melder v. Morris*, 27 F.3d 1097, 1100 n.6 (5th Cir. 1994); *Shapiro v. UJB Fin. Corp.*, 964 F.2d 272, 287-89 (3d Cir. 1996); *Degulis v. LXR Biotechnology, Inc.*, 928 F. Supp. 1301, 1310 (S.D.N.Y. 1996).

complaint give investors a perverse incentive to file multiple actions, alleging the claims in separate complaints. Such a practice needlessly multiplies proceedings, frustrating the purposes underlying Federal Rule of Civil Procedure 8(e)'s provision for pleading alternative – and even inconsistent – claims in the same complaint. Moreover, to the extent that §11 strict-liability claims can be dismissed because they are joined with §10(b) fraud claims, the fundamental legislative purposes underlying §11 are frustrated. Congress intended for §11 to relieve plaintiffs of the burden of proving fraud, mistake, or even negligence, by imposing *strict liability* on the issuer of securities. By applying the requirements for pleading fraud to §11 claims, some federal courts have effectively rewritten the substantive law, placing on plaintiffs the very burdens that Congress intended to eliminate.

Because fraud and nonfraud remedies under the securities laws naturally overlap, *Huddleston*, 382 U.S. at 380-87, plaintiffs often join claims for both in one complaint.[11] Most courts then apply the appropriate substantive standards and procedural rules to each – applying Rule 9(b) only to the fraud claims but not to §11 claims.[12] This is clearly correct under Rule 8(e)(2), which

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[11] *See, e.g., Kaplan v. Rose*, 49 F.3d 1363 (9th Cir. 1994); *In re Software Toolworks Sec. Litig.*, 50 F.3d 615 (9th Cir. 1995); *In re Worlds of Wonder Sec. Litig.*, 35 F.3d 1407 (9th Cir. 1994), *cert. denied*, ___ U.S. ___, 116 S. Ct. 277 (1995).

[12] *See In re AnnTaylor Stores Sec. Litig.*, 807 F. Supp. 990, 1003 (S.D.N.Y. 1992); *accord, e.g., In re Chambers Dev. Sec. Litig.*, 848 F. Supp. 602, 624 (W.D. Pa. 1994); *In re Marion Merrell Dow Sec. Litig.*, [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶97,776, at 97,764 n.3 & 97,770-71 (W.D. Mo. October 4, 1993); *In re Consumers Power Co. Sec. Litig.*, 105 F.R.D. 583, 594 (E.D. Mich.

states that a party "may set forth two or more statements of a claim . . . alternately . . . either in one count . . . or in separate counts." It mandates that "[w]hen two or more statements are made in the alternative and one of them if made independently would be sufficient, *the pleading is not made insufficient by the insufficiency of one or more of the alternative statements.*" *Id.* Rule 8(e)(2) is clear: "A party may also state as many separate claims . . . as the party has *regardless of consistency.*"[13]

The Complaint in this case pleads the §11 claim *as a separate* claim for relief. It explicitly states that the §11 claim is based on the Complaint's allegations of false or misleading statements in the prospectus "except allegations of fraud."[14] It is not clear what plaintiffs could have

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1985); *Seidel v. Public Serv. Co.*, 616 F. Supp. 1342, 1357 (D.N.H. 1985); *see, e.g., In re College Bound Consol. Litig.*, [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶98,310, at 90,135 (S.D.N.Y. May 4, 1994); *In re Jiffy Lube Sec. Litig.*, 772 F. Supp. 258, 260 (D. Md. 1991); *In re Lilco Sec. Litig.*, 625 F. Supp. 1500, 1502 (E.D.N.Y. 1986).

[13] *Id.*; *see In re Lilco Sec. Litig.*, 625 F. Supp. at 1505 (refusing to read complaint's allegations of fraud into its §11 claims).

[14] ER 45:¶76. The opinion below acknowledges that plaintiffs' Complaint "specifically disclaimed any allegations of fraud with respect to its Section 11 claims," but holds that "[t]hese nominal efforts are unconvincing where the gravamen of the complaint is plainly fraud and *no effort is made to show any other basis for the claims* levied [*sic*] at the Prospectus." 11a n.2. But the procedural posture of the case did not require plaintiffs to "show" anything. Because this appeal arises on a Rule 12(b)(6) motion to determine whether a claim for relief is stated, plaintiffs were under no obligation to prove their case. *See Scheuer v. Rhodes*, 416 U.S. 232, 236-37 (1974); *Conley v. Gibson*, 355 U.S. 41, 45-46 (1957). To plead and prove a prima facie case

done, short of dropping their §10(b) claim, to satisfy the Ninth Circuit that the §11 claim was not based on allegations of fraud. Inevitably, some investors, hoping to avoid this quandary, will feel compelled to file *two separate complaints* in order to avoid application of Rule 9(b) to §11 claims.[15] The wastefulness of such a practice is obvious, and is precisely what Rule 8's provisions for pleading in the alternative are designed to avoid. Review by this Court is needed to end conflict among the lower courts and to restore common sense in the application of pleading rules to §11 claims, avoiding needless multiplication of proceedings.

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under §11 *does not even require a plaintiff to plead or to establish negligence.* Stac faced *strict liability* under §11, not negligence liability, and to the extent the "due diligence" defense available to other defendants implicates a negligence standard, *see Hochfelder*, 425 U.S. at 208, *defendants "bear the burden of demonstrating due diligence" as an affirmative defense. Huddleston*, 459 U.S. at 382; *see In re Software Toolworks Sec. Litig.*, 50 F.3d 615, 621 (9th Cir. 1995); *Kaplan v. Rose*, 49 F.3d 1363, 1371 (9th Cir. 1994). Plaintiffs, of course, are "not required to plead on the subject of an anticipated affirmative defense." *United States v. McGee*, 993 F.2d 184, 187 (9th Cir. 1993).

[15] *See, e.g., Shaw v. Digital Equip. Corp.*, 82 F.3d 1194, 1201, 1222-23 (1st Cir. 1996). In *Shaw* plaintiffs filed separate complaints, one seeking relief under both §10(b) and the other under §11 in order to avoid having the nonfraud §11 claims dismissed under Rule 9(b). *Id.* It is, however, not even clear that a two-complaint strategy will always work. A court willing to apply fraud pleading rules to a §11 claim in the same complaint, as the court below did, may well be willing to apply fraud rules to a §11 claim brought by a plaintiff who has asserted a fraud claim, arising out of the same circumstances, in another court.

Review by this Court also is needed because conflict among the lower courts impairs effective enforcement of the securities laws, frustrating the legislative intent behind §11. In *Herman & MacLean v. Huddleston*, 459 U.S. 375 (1983), this Court held that investors are entitled to pursue §11 and §10(b) claims *cumulatively*, as part of their full range of remedies under the Securities Act and the Exchange Act. 459 U.S. at 386. For claims under Securities Act §11 and claims under Exchange Act §10(b) have different elements and serve different purposes. *See Huddleston*, 459 U.S. at 380-87. Section 10(b) requires proof of fraudulent intent, or scienter, *id.* at 383-84, but §11 was framed so that proof of fraud is not required, and the burden of proof on due diligence – when relevant – is shifted to defendants. *Id.* at 381-82.

Huddleston reasoned that "[i]t would be anomalous indeed if the special protection afforded to purchasers in a registered offering by the 1933 Act were deemed to deprive [investors] of the protections against manipulation and deception that §10(b) makes available to all persons who deal in securities." 459 U.S. at 383. It is even stranger still that an allegation that §10(b) was violated by intentional wrongdoing could deprive investors of the right to pursue a remedy under §11 – although that is exactly what has happened in this case. This "conflict[s] with the basic purpose of the 1933 Act: to provide greater protection to purchasers of registered securities." 459 U.S. at 382.

Congress believed that "*[t]he provisions throwing upon the defendant in suits under sections 11 and 12 the burden of proof* to exempt himself *are indispensable* to make the

buyer's remedies under these sections practically effective," for "[e]very lawyer knows that with all the facts in the control of the defendant it is practically impossible for a buyer to prove a state of knowledge or a failure to exercise due care on the part of defendant." H.R. Rep. No. 85, 73d Cong., 1st Sess. at 9 (1933).

Thus, review by this Court is necessary to restore the statutory balance enacted by Congress.

C. The Ninth Circuit's Holding That "No Assurance" Disclaimers Provide Immunity From Suit Conflicts With Precedents Of Other Circuits

Plaintiffs alleged that Stac's financial statements were false because the reserve for returns was unreasonably low, causing the Company's earnings to be overstated in the prospectus. But the Ninth Circuit concluded that liability is foreclosed *as a matter of law*, and that the complaint could be dismissed at the threshold, because the prospectus warned *"there can be no assurance"* the reserves would be adequate. 22a.

This conflicts with other circuits' holdings that such generic "warnings" of the obvious cannot foreclose liability as a matter of law. *See, e.g., United States v. Morris*, 80 F.3d 1151, 1166-68 (7th Cir. 1996), *cert. denied*, ___ U.S. ___, 117 S.Ct. 181 (1996); *Rubinstein v. Collins*, 20 F.3d 160, 163-64, 166-68 (5th Cir. 1994). On the other hand, some appellate decisions accept "no assurance" disclaimers, holding that they do provide immunity from liability as a

matter of law.[16] Review is needed because the lower courts are divided on the effect of a "no assurance" disclaimer. This split of authority goes to the heart of the "bespeaks caution doctrine," which the circuit courts have developed to provide " 'a mechanism by which a court can rule as a matter of law that defendants' forward-looking representations contained enough cautionary language or risk disclosures to protect a defendant against claims of securities fraud.' "[17]

The prospectus in this case stated:

> Although the Company *believes that it provides adequate allowances* for returns, *there can be no assurance* that actual returns in excess of recorded allowances will not result in a material adverse effect on the Company's business, operating results or financial condition.

ER 45:¶50; 22a.

Treating Stac's overstated financial results as a mere *"projection"* the Ninth Circuit held "that investors were

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[16] *See, e.g., Olkey v. Hyperion 1999 Term Trust, Inc.*, No. 95-7823, 1996 U.S. App. LEXIS 26784, at *23 (2d Cir. Oct. 15, 1996); *Glassman v. Computervision Corp.*, 90 F.3d 617, 635-634 & n.27 (1st Cir. 1996); *Romani v. Shearson Lehman Hutton*, 929 F.2d 875, 879 (1st Cir. 1991); *Luce v. Edelstein*, 802 F.2d 49, 56 (2d Cir. 1986); *In re Computervision Sec. Litig.*, 869 F. Supp. 56, 61 (D. Mass. 1994); *Stevens v. Equidyne Extractive Indus. 1980 Petro/Coal Program 1*1*, 694 F. Supp. 1057, 1063-64 (S.D.N.Y. 1988).

[17] 19a-20a (quoting *Fecht v. Price Co.*, 70 F.3d 1078, 1081 (9th Cir. 1995), *cert. denied*, ___ U.S. ___, 116 S.Ct. 1422 (1996)); *see In re Worlds of Wonder Sec. Litig.*, 35 F.3d 1407, 1420 (9th Cir. 1994), *cert. denied*, ___ U.S. ___, 116 S.Ct. 185 (1995); *In re Donald J. Trump Casino Sec. Litig.*, 7 F.3d 357, 364, 371-73 (3d Cir. 1993).

specifically and adequately cautioned about the relevant risks," so that any misrepresentation was "more than adequately covered by the bespeaks caution doctrine." 22a. This holding cannot be reconciled with the law of other circuits, that the "bespeaks-caution doctrine," because it applies only to projections of the future, does not protect concealment of presently existing conditions or intentions. *See, e.g., In re Westinghouse Sec. Litig.*, 90 F.3d 696, 708-10 (3d Cir. 1996); *Shaw*, 82 F.3d at 1213 (emphasis in original).

As the First Circuit explained in *Shaw v. Digital Equipment Corp.*, 82 F.3d 1194, 1212-14 (1st Cir. 1996): "To the extent that plaintiffs allege that [a] reserve 'adequacy' statement encompasses [a] representation of *present fact*, and that such a representation was false or misleading when made, the surrounding cautionary language could not have rendered the statement immaterial as a matter of law." *Shaw*, 82 F.3d at 1213 (emphasis in original). Thus, according to the First Circuit, to the extent that inadequate reserves caused the Company's *historical financial results* to be overstated, the bespeaks caution doctrine cannot apply to financial statements. *See Shaw*, 82 F.3d at 1213. The decision below conflicts directly with *Shaw*.

Neither can the Ninth Circuit's holding in this case be reconciled with numerous additional precedents holding that a generic "no assurance" disclaimer cannot "bespeak caution" as a matter of law. The Seventh Circuit, for example, recently upheld *criminal fraud convictions* of bank officers for a false statement about the

adequacy of reserves for uncollectable loans, notwithstanding a "there can be no assurance" disclaimer.[18]

The Seventh Circuit rejected contentions that cautionary *"no assurance can be given"* statements necessarily "neutralized any fraud":

> *The language relied upon by defendants here does nothing more than to apprise potential investors that actual losses in the portfolio cannot now be predicted with absolute certainty.* . . . [T]he offering circular still advises that "based on its present analysis," bank management believes that "adequate provision" has been made for estimated losses in the loan portfolio. *The uncertain nature of predicting future loan losses does not neutralize the misleading character of this statement.* . . . The qualifying statements thus do not exhaust the capacity of the adequacy statement to mislead.

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[18] *United States v. Morris*, 80 F.3d 1151, 1166-68 (7th Cir. 1996), *cert. denied*, ___ U.S. ___, 117 S. Ct. 181 (1996). In *Morris*, two corporate officers were sentenced to 46 months in prison for a prospectus which said:

> *It is not presently possible to determine the actual losses that will ultimately be incurred* by the Savings Bank in connection with the collection of its loan portfolio and liquidation of real estate owned; however, the Savings Bank believes that, based on its present analysis, *adequate* provision has been made for estimated losses from these portfolios. However, *no assurance can be given* that additional provisions for losses on loans and real estate owned will not be required as a result of future economic conditions or other factors.

Id. at 1167.

Id. at 1168. If a "no assurance" disclaimer does not block criminal convictions for misleading statements, a fortiori it cannot immunize Stac from civil liability.

The Ninth Circuit holding in this case that a simple *"no assurance"* disclaimer protects false statements *as a matter of law* conflicts with many other decisions as well. In *Harden v. Raffensperger Hughes & Co.*, 65 F.3d 1392, 1404-06 (7th Cir. 1995), an issuer of securities warned that it might not be able to obtain federal insurance: " 'There is *no assurance* that either the FHLB application or the FDIC application will be approved.' " *Id.* at 1406. The Seventh Circuit held that this warning did not bar liability as a matter of law.

Similarly, in *Rubinstein v. Collins*, 20 F.3d 160 (5th Cir. 1994), a prospectus said that "[a]lthough there is insufficient production history and other data available to definitely quantify the proved reserves attributable" to a new oil well, the company believed the "well is a significant discovery that, when fully evaluated, could add substantially to the Company's oil and natural gas reserves." *Id.* at 163. The prospectus warned: *"There can be no assurance,* however, that subsequent production, drilling and other data will not cause the Company to reevaluate its assessment of the significance of this discovery." *Id.* at 163-64. The Fifth Circuit reversed a district court for holding that such "no assurance" disclaimers blocked liability as a matter of law.[19]

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[19] *Id.* at 166-68. The opinion below even conflicts with other decisions from the Ninth Circuit. In *Gray v. First Winthrop Corp.*, 82 F.3d 877 (9th Cir. 1996), another Ninth Circuit panel reversed summary judgment in a securities action – rejecting

Our securities markets are national in scope, and require uniform rules of liability – particularly for accounting misstatements. Irreconcilable conflicts on the effect of boilerplate "no assurance" disclaimers engender tremendous uncertainty regarding rules of liability under the federal securities laws and will lead to forum shopping. Only this Court can resolve the conflict among the lower courts regarding the nature and scope of the "bespeaks caution doctrine" and its application to "no assurance" disclaimers.

X. CONCLUSION

These issues go far beyond this case. The Ninth Circuit's ruling comes at a time when stock offerings are running at all-time high levels.[20] Full disclosure during the capital-formation process is mandated by §11 of the Securities Act, but under the decision below Rule 9(b)'s pleading requirements for fraud will block investor suits under a law that was passed to provide *strict liability* of the issuer. The decision below also will permit issuers of securities to assert false affirmative opinions concerning their finances and business – so long as they parrot the

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"no assurance" disclaimers in a prospectus. In *Gray*, the court held that such disclaimers are "so generalized in nature that a reasonable jury could nonetheless find the prospectus misleading." 82 F.3d at 884.

[20] "America's Amazing IPO Bonanza; It's Big, It's Powerful, and It Mints Millionaires," *Fortune*, May 27, 1996, at 76; "The Boom In IPO's," *Business Week*, Dec. 18, 1995, at 64; "New Stock Issues Go Up, Up, Up, And Wall Street Cries: More!," *Fortune*, Oct. 18, 1993, at 27; "The Art of The Deal," *Time*, Feb. 19, 1996, at 48.

meaningless, generic boilerplate that there can be "no assurance" they are correct.

Review by this Court thus is necessary to resolve conflicts among the circuits and to assure that the protections provided by Congress are not circumvented.

DATED: November 25, 1996

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[89 F.3d 1399]

FOR PUBLICATION

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

In re STAC ELECTRONICS SECURITIES LITIGATION	No. 94-56232
	D.C. No. CV-92-1120-JSR
TIMOTHY J. ANDERSON; NEIL SINGER; ARTHUR SINGER, on Behalf of Themselves and All Others Similarly Situated, *Plaintiffs-Appellants,* v. GARY W. CLOW; DOUGLAS WHITING; ROBERT JOHNSON; ALEX BROWN & SONS INCORPORATED; LAWRENCE FINCH, et al., *Defendants-Appellees.*	ORDER AND OPINION

Appeal from the United States District Court
for the Southern District of California,
John S. Rhoades, District Judge, Presiding.

Argued and Submitted Feb. 6, 1996.
February 6, 1996 – Pasadena, California

Opinion Filed May 7, 1996
Opinion Withdrawn July 16, 1996
Filed July 17, 1996

Before: J. Clifford Wallace, Warren J. Ferguson, and Thoms G. Nelson, Circuit Judges.

Opinion by Judge T.G. Nelson

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Steven M. Schaltz [sic], Wilson, Sonsini, Goodrich & Rosati, Palo Alto, California, and Charlene S. Shimada, McCutchen, Doyle, Brown & Enersen, San Francisco, California, for defendants-appellees.

ORDER

The opinion filed May 7, 1996, is withdrawn, and the enclosed opinion is substituted in its place. With this new opinion, appellant's petition for rehearing is denied and the suggestion for rehearing en banc is rejected as moot.

OPINION

T.G. NELSON, Circuit Judge:

The opinion filed May 7, 1996, is withdrawn, and the enclosed opinion is substituted in its place. With this new opinion, appellants' petition for rehearing is denied and the suggestion for rehearing en banc is rejected as moot.

OVER VIEW

Timothy J. Anderson and other class representatives (collectively "Anderson") who purchased stock in Stac

Electronics ("Stac") between May 7 and July 20, 1992, appeal the district court's dismissal of their class action under Sections 11 and 15 of the Securities Act of 1933, 15 U.S.C. §§ 77k, 77o, and Sections 10(b) and 20 of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78j(b) and 78t. Anderson alleges that Stac, certain of its officers and directors, and its lead underwriters, Alex. Brown & Sons, Inc., and Montgomery Securities ("Alex. Brown" and "Montgomery," respectively; collectively, "Underwriters"), made material misrepresentations or omissions regarding Stac's initial public offering ("IPO") of May 7, 1992. We have jurisdiction under 28 U.S.C. § 1291, and we affirm.

FACTS AND PROCEDURAL HISTORY

This case arises from Stac's May 7, 1992, IPO of stock in its computer products company. Stac's most prominent product was the "Stacker," a data-compressing device which doubles storage capacity of disk drives in computers using Microsoft's MS-DOS and compatible systems.

The district court related the following facts, which are not disputed by the parties:

> Before it went public, Stac's performance was mixed: it reported net losses per share in 1988, 1989, and 1990, and a net income per share of $.01 in 1991. It also reported revenues hovering around three quarters of a million dollars for 1988 and 1989, with increased revenues in 1990 (to $1.7 million) and 1991 (to $8.3 million).

> There was a pronounced move upward – in both revenues and earnings per share – immediately prior to the initial public offering of Stac stock. While Stac reported revenues of $2.3 million and a loss of $.04 per share in the six months prior to March 31, 1991, it reported revenues of $17 million and earnings of $.21 per share in the six months prior to March 31, 1992. The increased revenues and earnings for the 1992 six month period derived from sales of Stacker.
>
> On May 7, 1992, Stac went public, with an initial offering of 3,000,000 shares of common stock. The stock was sold to the public at $12.00 a share, with the individual named Defendants – except for Hoff, Finch and Robelen – selling some 508,000 shares. Neither Hoff, Finch, Robelen nor any of the venture capital Defendants is alleged to have sold any Stac stock during the class period [May 7 to July 20, 1992]. Defendants Alex. Brown & Sons, Inc. and Montgomery Securities acted as co-lead underwriters for the offering; they received substantial fees – some $2.5 million – for their services.

In connection with the IPO, Stac issued a Registration Statement and Prospectus ("Prospectus"), dated May 7, 1992, which included a four-page section on risk factors warning investors, *inter alia*, of Stac's competition, its dependence on Stacker, its reliance on distributors, its limited source of supply, and the potential volatility of its stock price. [*See* Prospectus at 5-8.] The Prospectus specifically discussed Microsoft's competitive threat, Stac's return policy and return allowances, and the possible effects on revenues of "channel fill," or heavy purchasing

by distributors immediately following the introduction of a new product. [*Id.*]

Apart from the Prospectus, information about Stac was disseminated to the public through "roadshow" presentations preceding the IPO and through analysts' reports and press statements by Stac officers and Underwriters following the IPO. All of these portrayed Stac as a good investment. While these portrayals at first seemed accurate – Stac rose to $15 after the IPO – success was short-lived. Stac's stock price fell on July 2, 1992, on the heels of another computer software company's announcement of poor third quarter results.

Stac Director Gary Clow ("Clow") and both Underwriters made statements to *Dow Jones News Wire* distinguishing Stac from the faltering software company. While Alex. Brown continued to rate Stac highly, Montgomery reduced its rating and earnings estimate for Stac on July 6, 1992. On July 20, 1992, Stac disclosed a disappointing third quarter performance, and on July 21, 1992, Stac stock declined to $5.50 per share. Within two days, plaintiffs filed suit. This initial suit was consolidated in the First Amended Class Action Complaint ("the FAC"), filed December 4, 1992.

The FAC asserted four claims for relief: I) against all defendants, alleging violation of Section 11 of the Securities Act, 15 U.S.C. § 77k(a); II) against all individual defendants and venture capital defendants, alleging controlling person liability under Section 15 of the Securities Act, 15 U.S.C. § 77o; III) against all defendants, alleging violations of Section 10(b) of the Exchange Act, 15 U.S.C. § 78j(b), and Rule 10b-5 of the Securities and Exchange

Commission ("SEC"), 17 C.F.R. § 240.10b-(5); and IV) against all individual defendants and venture capital defendants, alleging controlling person liability[1] under Section 20(a) of the Exchange Act, 15 U.S.C. § 78t.

The complaint basically alleged that Stac went public knowing, but without disclosing, that Microsoft was about to come out with a competitive product (a new version of DOS incorporating Stacker-like data compression capabilities) that would take away Stac's market; that Stac engaged in sham licensing negotiations with Microsoft in order to stall introduction of its new product until Stac could make an IPO and unload stock; and that Stac insiders artificially inflated Stac's stock price prior to the IPO through channel "stuffing" and other fraudulent practices.

The district court dismissed the FAC with leave to amend in a detailed order dated September 17, 1993. *Anderson v. Clow,* Fed. Sec. L. Rep. (CCH) ¶ 97,807 at 97,994-95 (S.D. Cal. 1993). The district court held that plaintiffs had failed to state a claim against Stac, the Underwriters, or any other named defendant, primarily on the basis of its finding that, to the extent it was required to do so, Stac had adequately disclosed all purported omissions in its Prospectus in a way that rendered the Prospectus not misleading. The order also stayed discovery.

On November 18, 1993, the plaintiffs filed a Second Amended Complaint ("the SAC"), asserting the same

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[1] Plaintiffs on appeal offer no arguments concerning controlling person liability under Section 20 or under Section 15.

claims as the FAC and adding nine new individual defendants. The district court dismissed the SAC with prejudice for failure to state a claim under Fed. R. Civ. P. 12(b)(6) and for failure to meet the particularity requirements of Fed. R. Civ. P. 9(b). *Anderson v. Clow*, Fed. Sec. L. Rep. (CCH) ¶ 98,367 (S.D. Cal. 1994). Like the first order, the order appealed from is extremely thorough. Anderson's appeal was timely.

DISCUSSION

Standard of review.

Dismissal pursuant to Fed. R. Civ. P. 12(b)(6) is reviewed *de novo*. *In re VeriFone Sec. Litig.*, 11 F.3d 865, 868 (9th Cir. 1993). "All allegations of material fact are taken as true and construed in the light most favorable to the plaintiff." *In re Wells Fargo Sec. Litig.*, 12 F.3d 922, 925 (9th Cir. 1993), *cert. denied*, 115 S. Ct. 295 (1994). However, "[c]onclusory allegations of law and unwarranted inferences are insufficient to defeat a motion to dismiss for failure to state a claim." *VeriFone*, 11 F.3d at 868.

I

Primary Liability.

Anderson argues that by "falsifying" its financial statements and failing to disclose pertinent information in its possession regarding Microsoft's plans to include data compression in its newest version of DOS, Stac misled investors and violated Section 11 of the Securities Act of 1933, 15 U.S.C. § 77k(a), Section 10(b) of the Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5 of the Securities and Exchange Commission ("SEC"), 17

C.F.R. § 240.10b-(5). The district court held that the SAC failed to state a claim under Section 11, Section 10(b), or Rule 10b-5. It further held that the SAC failed to plead with sufficient particularity its Section 10(b) and Rule 10b-5 claims, as required by Fed. R. Civ. P. 9(b). We address the adequacy of Anderson's claims *de novo. Id.*

On appeal, Anderson stresses the following: Stac and its officers: 1) failed to disclose imminent competition from Microsoft and deliberately stalled licensing negotiations with Microsoft in order to delay Microsoft's market entry; and 2) falsified its financial statements by artificially inflating reported results through channel "stuffing," accomplished by offering customers "special terms," including discounts and exceptional rights of return; understating its existing reserves; and failing to disclose Stac's "inevitable" impending decline.

Both Section 11 of the Securities Act and Section 10(b) of the Exchange Act require a plaintiff "adequately [to] allege a material misrepresentation or omission." *Id.* Section 11 creates a private remedy for any purchaser of a security if any part of the registration statement,

> when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading. . . .

15 U.S.C. § 77k(a). "The plaintiff in a § 11 claim must demonstrate (1) that the registration statement contained an omission or misrepresentation, and (2) that the omission or misrepresentation was material, that is, it would have misled a reasonable investor about the nature of his

or her investment." *Kaplan v. Rose*, 49 F.3d 1363, 1371 (9th Cir. 1994), *cert. denied*, 116 S. Ct. 58 (1995). "No scienter is required for liability under § 11; defendants will be liable for innocent or negligent material misstatements or omissions." *Id.* (citing *Herman & MacLean v. Huddleston*, 459 U.S. 375 (1983)).

In contrast to Section 11, Section 10(b) requires scienter and covers statements made not only in the registration statement or prospectus but also in other documents and in oral communications. Section 10(b) of the Exchange Act of 1934 makes it unlawful "for any person . . . [t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe." 15 U.S.C. § 78j(b). SEC Rule 10b-5, promulgated under the authority of Section 10(b) provides that:

> It shall be unlawful for any person . . .
>
> > (a) To employ any device, scheme, or artifice to defraud,
> >
> > (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or
> >
> > (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

> in connection with the purchase or sale of any security.

17 C.F.R. § 240.10(b)(5).

It is well established that claims brought under Rule 10b-5 and Section 10(b) must meet the particularity requirements of Fed. R. Civ. P. 9(b). *Wool v. Tandem Computers, Inc.*, 818 F.2d 1433, 1439 (9th Cir. 1987). Rule 9(b) states that, "[i]n all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity. Malice, intent, knowledge, and other condition of mind of a person may be averred generally."

We closely examined the role of Rule 9(b) in the securities law context in our recent en banc decision, *In re GlenFed, Inc. Sec. Litig.*, 42 F.3d 1541 (9th Cir. 1994) (en banc) (*"GlenFed II"*) (discussing pleadings in the context of § 10(b) claims). With respect to scienter, we held that plaintiffs need only "say[ ][it] existed." *Id.* at 1547. However, we went on to hold that plaintiffs "must aver with particularity the circumstances constituting the fraud." *Id.* We explained that time, place and content allegations, while necessary, are insufficient by themselves to state a claim for fraud. *Id.* at 1547-48. "The plaintiff must set forth what is false or misleading about a statement, and why it is false. In other words, the plaintiff must set forth an explanation as to why the statement or omission complained of was false or misleading." *Id.* at 1548. Further, the statement or omission must be shown to have been false or misleading *when made*. *Id.* at 1548-49.

We agree with Anderson that our clarification of the scienter requirement in *GlenFed II* nullifies the district

court's conclusion that Anderson's Section 10(b) and Rule 10b-5 claims must fail because Anderson did not plead scienter with particularity. The SAC sufficiently avers fraudulent intent on the part of Stac and its officers for the purpose of Rule 9(b). However, the remainder of our decision in *GlenFed II* supports the conclusion that Anderson's claims must nevertheless fail if, as the district court found, Anderson failed to plead the underlying fraud with particularity. [See ER 80 at 16-31, 39, 45.]

Anderson disputes the applicability of Rule 9(b) to its Section 11 claims. The district court considered plaintiffs' Sections 11 and 10(b) claims separately, dismissing the former under Rule 12(b)(6) and the latter under Rule 9(b), though it applied similar standards and reasoning to each. We recently affirmed a district court's dismissal of 1933 and 1934 Act claims, including Section 11 claims, for failure to satisfy Fed. R. Civ. P. 9(b). *In re GlenFed, Inc. Sec. Litig.*, 60 F.3d 591, 592 (9th Cir. 1995) ("*GlenFed III*") (on remand from en banc decision, 42 F.3d 1541 (9th Cir. 1994)). We now clarify that the particularity requirements of Rule 9(b) apply to claims brought under Section 11 when, as here, they are grounded in fraud.[2] *See Melder v. Morris*, 27 F.3d 1097, 1100 n. 6 (5th Cir. 1994) (holding Rule 9(b) applies to 1933 Securities Act claims when they are grounded in fraud rather than negligence, and applying the rule to §§ 11 and 12(2) claims); *Shapiro v. UJB Fin.*

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[2] Anderson argues that it specifically disclaimed any allegations of fraud with respect to its Section 11 claims. These nominal efforts are unconvincing where the gravamen of the complaint is plainly fraud and no effort is made to show any other basis for the claims levied at the Prospectus.

Corp., 964 F.2d 272, 288 (3d Cir.) (observing that "the plain language [of Rule 9(b)] clearly encompasses § 11 and § 12(2) claims based on fraud," but reserving judgment on the issue of whether the rule applies to claims that a defendant negligently violated these sections), *cert. denied*, 506 U.S. 934 (1992); *Sears v. Likens*, 912 F.2d 889, 892-93 (7th Cir. 1990) (applying Rule 9(b) to 1933 Securities Act claims sounding in fraud).

Rule 9(b) serves to give defendants adequate notice to allow them to defend against the charge and to deter the filing of complaints "as a pretext for the discovery of unknown wrongs," to protect professionals from the harm that comes from being subject to fraud charges, and to "prohibit [ ] plaintiff[s] from unilaterally imposing upon the court, the parties and society enormous social and economic costs absent some factual basis." *Semegen v. Weidner*, 780 F.2d 727, 731 (9th Cir. 1985). Because the same policy considerations apply to Section 11 claims sounding in fraud, we hold that persons making such claims must state with particularity the circumstances constituting the alleged fraud.[3]

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[3] Of course, the scienter requirement of Rule 9(b) does not apply to Section 11 claims, as such claims may be based on negligent or innocent misstatements or omissions. *Herman & MacLean v. Huddleston*, 459 U.S. 375, 382 (1983); *Kaplan v. Rose*, 49 F.3d 1363, 1371 (9th Cir.1994) (citations omitted), *cert. denied*, 116 S.Ct. 58 (1995).

A. *Stac's Prospectus.*

The district court found that all of the omissions alleged by Anderson were either actually disclosed, or need not have been disclosed, in Stac's prospectus.[4] The "materiality" of an omission is a fact-specific determination that should ordinarily be assessed by a jury. *Fecht v. The Price Co.*, 70 F.3d 1078, 1080-81 (9th Cir. 1995), *cert. denied*, 116 S. Ct. 1422 (1996). "[O]nly if the adequacy of the disclosure or the materiality of the statement is so obvious that reasonable minds could not differ are these issues appropriately resolved as a matter of law." *Id.* at 1081 (quotations and alterations omitted).

1. *Microsoft's plans to include data compression.*

The gravamen of Anderson's complaint concerns Stac's alleged failure to disclose its knowledge of Microsoft's plans to introduce data compression in its upcoming version of DOS. According to Anderson, Stac entered into "sham" licensing negotiations with Microsoft merely

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[4] The district court considered the full text of the Prospectus, including portions which were not mentioned in the complaints. We note that such consideration is appropriate in the context of a motion to dismiss, and does not convert the motion into one for summary judgment. " '[D]ocuments whose contents are alleged in a complaint and whose authenticity no party questions, but which are not physically attached to the pleading, may be considered in ruling on a Rule 12(b)(6) motion to dismiss.' " *Fecht v. The Price Co.*, 70 F.3d 1078, 1080 n. 1 (9th Cir.1995) (quoting *Branch v. Tunnell*, 14 F.3d 449, 454 (9th Cir.), *cert. denied*, 114 S.Ct. 2704 (1994)), *cert. denied*, 116 S.Ct. 1422 (1996).

to stall Microsoft's introduction of its new product. In the SAC, Anderson also alleged that Stac's patents were inadequate to prevent others from using its technology to create competitive products. Prior to the district court's ruling, however, Stac won a $120 million judgment against Microsoft for patent infringement relating to Stacker. *See Stac Electronics v. Microsoft Corp.*, Civil No. 93-0413-ER (Bx) (C.D.Cal. Feb. 23, 1994). The district court properly took judicial notice of this judgment in determining that the proprietary and patent information provided in the Prospectus was not misleading. [ER 80 at 17.] Anderson does not raise the patent issue on appeal.

Regarding the threat of Microsoft "looming," the district court correctly observed that the Prospectus makes detailed disclosures concerning the risk of competition. For instance, the Prospectus states that "[a] number of competitors offer products that currently compete with [Stac's] products" and that these companies "could seek to expand their product offerings by designing and selling products using data compression or other technology that could render obsolete or adversely affect sales of [Stac's] products." [Prospectus at 5.] After noting Stac's dependence on sales of DOS-compatible products, the Prospectus observes that:

> One developer of a compatible operating system has licensed a competitive data compression product for incorporation into the latest version of the operating system. *There can be no assurance that Microsoft . . . will not incorporate a competitive data compression technology* in their products or that such a technology will not emerge as an industry standard.

[*Id.* (emphasis added).] Further, the Prospectus reveals that "[Stac] has licensed and intends to license portions of its core technology to others," a practice which it cautions could result in more competition and price reductions. [*Id.*]

Anderson alleges that the "no assurance" language is inadequate and that Stac committed fraud because it *knew* that Microsoft was going to come out with a competitive product, but masked this knowledge as a contingency. Anderson quotes repeatedly the following statement: " 'To warn that the untoward may occur when the event is contingent is prudent; to caution that it is only possible for the unfavorable events to happen when they have already occurred is deceit.' " *In re Convergent Technologies Sec. Litig.*, 948 F.2d 507, 515 (9th Cir. 1991) (quoting *Huddleston v. Herman & MacLean*, 640 F.2d 534, 544 (5th Cir. 1981), *aff'd in relevant part and rev'd in part on other grounds*, 459 U.S. 375 (1983)).

We have rephrased this principle as follows: " 'There is a difference between knowing that any product-in-development may run into a few snags, and knowing that a particular product has already developed problems so significant as to require months of delay.' " *Id.* (quoting *In re Apple Computer Sec. Litig.*, 886 F.2d 1109, 1115 (9th Cir. 1989), *cert. denied*, 496 U.S. 943 (1990)). The latter scenario characterizes the situation we encountered in *Warshaw v. Xoma Corp.*, 74 F.3d 955 (9th Cir. 1996). Corporate officers of Xoma, a biotech company which had yet to make a profit on its research, assured stockholders that FDA approval of its new drug was imminent, in spite of knowledge that the drug might not work and was unlikely to receive such approval. *Id.* at 957-59. Anderson

has not alleged any such contradictory statements here. In *Convergent*, we proceeded to distinguish the case before us from the Fifth Circuit case quoted, noting that Convergent's prospectus "virtually overflow[ed]" with risk factors, and to hold that the defendant company was not obliged to disclose its internal projections because such projections are tentative. 948 F.2d at 515-16. We cited as adequate multiple warnings in the Convergent prospectus stating that "there is no assurance" of financial success given a variety of named obstacles to production. *Id.* We therefore cannot agree with Anderson's characterization of Stac's "no assurance" language as "misleading" or inadequate.

Anderson argues that Stac should have explicitly disclosed its ongoing negotiations with Microsoft and its knowledge that Microsoft intended to introduce data compression technology in its new version of DOS. In short, Anderson suggests that Stac was obliged not only to report on its own product line and marketing plans, but to report on and make predictions regarding *Microsoft's* intentions.

Stac counters, and we have held, that a company is not required to forecast future events or to caution "that future prospects [may not be] as bright as past performance." *In re Worlds of Wonder Sec. Litig.*, 35 F.3d 1407, 1420 (9th Cir. 1994) ("*WOW*") (" 'Absent allegations that [the issuer] withheld financial data or other existing facts from which forecasts are typically derived, the alleged omissions are not of material, actual facts. Therefore, the forecasts need not have been disclosed, and the failure to

make the omitted forecasts did not render the other statements that were made misleading.' ") (quoting *VeriFone*, 11 F.3d at 869), *cert. denied*, 116 S. Ct. 185 (1995).

We agree with Stac that another company's plans cannot be known to a certainty. Even assuming, as we must, that Microsoft had informed Stac that it planned to introduce data compression, Stac could not have known whether or not Microsoft would truly do so. As Stac points out, the contingency of the event is underscored by the fact that a competitive product was liable to violate Stacker's patent, as borne out by the state judgment against Microsoft. Also, the market already knew of the potential for Microsoft's inclusion of data compression technology, as Anderson alleged in the FAC. *See* n. 6, *infra*.

2. *Stac's financial statements.*

Anderson also argues that Stac falsified its financial statements in the Prospectus by failing to disclose its channel-"stuffing" practices, its inadequate reserves, and its liberal distribution terms, all of which Anderson characterizes as illegitimate "borrowing" against the future to inflate its returns in the quarter prior to the public offering.

As the district court found, however, the Prospectus describes the phenomenon of channel-filling with its attendant risks, spells out Stac's liberal return policy, warns investors of Stac's exposure to the risk of product returns, and advises investors not to predict future returns on the basis of the results of any single quarter.

The following excerpts from the Propectus are instructive.

a. Channel fill:

> The Company's results of operation are subject to significant quarterly variations as a result of a number of factors and risks, including . . . the phenomenon of "channel fill". . . . Channel fill often occurs following the introduction of a new product or a new version of a product as distributors buy significant quantities of a new product or version in anticipation of sales of such product or version. Following such purchases, the rate of distributor's purchases may decline.

[Prospectus at 16.]

b. Return policy, risk of returns, and return allowances:

> During the first six months of fiscal 1992 the Company's distributors and software reseller returned substantial quantities of the initial version of Stacker in exchange for version 2.0 of Stacker. Such returns did not materially impact operating results for the first six months of 1992, however, as allowances for returns of the initial version of Stacker had been established in fiscal 1991.
>
> * * *
>
> Like other manufacturers of packaged software products, the Company is exposed to the risk of product returns from distributors and direct reseller customers.

[*Id.* at 6-7.]

> The Company's return policy allows its distributors to return any new, unused product in the

> distributor's inventory within . . . 60 days from the notice of discontinuance of any product, or any version of a product, for a credit or cash refund. Although the Company believes that it provides adequate allowances for returns, there can be no assurance that actual returns in excess of recorded allowances will not result in a material adverse effect on business, operating results and financial condition.

[*Id.* at 22.]

> c. Quarterly results:
>
> The Company has historically experienced significant fluctuations in its operating results, including net income, and anticipates that these fluctuations will continue. The Company operates with relatively little backlog, and the majority of its revenues in each quarter results form [sic] orders received in that quarter. Consequently, if near-term demand for the Company's product weakens in a given quarter, the Company's operating results for that quarter would be adversely affected. . . . As a result, the Company believes that period-to-period comparisons of its operating results should not be relied upon as an indication of future performance.

[*Id.* at 6. *See also id.* at 15, 17.]

The parties dispute whether, as a matter of law, these statements can be said to disclose purported omissions and adequately caution investors as to specific risks. We have recognized that the "bespeaks caution" doctrine " 'provides a mechanism by which a court can rule as a matter of law that defendants' forward-looking representations contained enough cautionary language or risk

disclosure to protect the defendant against claims of securities fraud.' " *Fecht*, 70 F.3d at 1081 (quoting *WOW*, 35 F.3d at 1413) (alterations omitted).[5] The doctrine serves to "minimize the chance that a plaintiff with a largely groundless claim will bring a suit and conduct extensive discovery in the hopes of obtaining an increased settlement." *WOW*, 35 F.3d at 1415 (quotations omitted.)

However, "[i]nclusion of *some* cautionary language is not enough to support a determination as a matter of law that defendants' statements were not misleading." *Fecht*, 70 F.3d at 1082 (emphasis added); *see also Gray First Winthrop Corp., as amended*, 1996 WL 350014, *7 (9th Cir. May 2, 1996) (holding cautionary language inadequate where plaintiffs alleged specific factual misrepresentations and disclosed risks were "so generalized in nature that a reasonable jury could nonetheless find the prospectus misleading."). "A motion to dismiss for failure to state a claim will succeed only when the statements containing defendants' challenged documents include *enough* cautionary language or risk disclosure that reasonable minds could not disagree that the challenged statements were not misleading." *Fecht*, 70 F.3d at 1082 (citation and quotations omitted).

The district court did not rely on the bespeaks caution doctrine here because it found that the Prospectus contained no forward-looking representations. [SER 37:23.] By definition, the bespeaks caution doctrine applies only to affirmative, forward-looking statements.

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[5] The bespeaks caution doctrine applies to both Section 10(b) and Section 11 claims. *WOW*, 35 F.3d at 1415 n. 3.

Id. at 1413 n. 2. However, we have observed that the doctrine "merely represents the pragmatic application of two fundamental concepts in the law of securities fraud: materiality and reliance." *WOW*, 35 F.3d at 1414.

> [T]he 'bespeaks caution' doctrine has developed to address situations in which optimistic projections are coupled with cautionary language . . . affecting the reasonableness of reliance on and the materiality of those projections. To put it another way, the 'bespeaks caution' doctrine reflects the unremarkable proposition that statements must be analyzed in context.

Id. (quoting *Rubinstein v. Collins*, 20 F.3d 160, 167 (5th Cir. 1994)). In WOW, we approved the district court's application of the "*Basic* test of materiality" to plaintiffs' claims concerning material omissions, which states that for nondisclosure to be actionable, " 'there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.' " *Id.* at 1413 n. 2 (quoting *Basic, Inc. v. Levinson*, 485 U.S. 224, 231-31 (1988)) (alterations omitted). *Cf. Gray*, 1996 WL 350014 at *6 (concluding that bespeaks caution doctrine was relevant in determining whether the prospectus as a whole was misleading as a matter of law, where alleged misrepresentations concerned matters of historical fact).

Here, Anderson characterizes certain claims regarding Stac's Prospectus as both material omissions and misstatements. For example, Anderson alleges that Stac failed to disclose its inadequate reserves for returns. At

the same time, Anderson characterizes the Prospectus's statement that "the Company believes it provides adequate allowances for returns" as an affirmative misstatement. The quoted sentence reads in full: "Although the Company believes it provides adequate allowances for returns, there can be no assurance that actual returns in excess of recorded allowances will not result in a material adverse effect on business, operating results, and financial condition." [Prospectus at 7.]

Anderson further charges that Stac attributes its increase in revenues in the second quarter of 1992 to awards and favorable reviews, when in fact the increase was due to channel-fill, or what Anderson terms channel-"stuffing." In fact, Stac's conjecture that the 1992 increases were due "partially" to awards and reviews appears in the context of a section on "quarterly trends" which leads off with an explanatory and cautionary statement about the effects of channel fill on revenue. [Prospectus at 16-17.] Analyzing the quoted statements in context leads to the inexorable conclusion that investors were specifically and adequately cautioned about the relevant risks. Insofar as Stac's alleged misstatements can be viewed as "optimistic projections," they are more than adequately covered by the bespeaks caution doctrine.

Bespeaks caution aside, Anderson fails to make precise allegations explaining how the alleged misstatements were misleading or untrue when made. "The plaintiff must set forth what is false or misleading about a statement, and why it is false. In other words, the plaintiff must set forth an explanation as to why the statement or omission complained of was false or misleading." *GlenFed*

II, 42 F.3d at 1548. Statements which imply factual assertions are actionable if any one of the following statements is inaccurate: "(1) that the statement is genuinely believed, (2) that there is a reasonable basis for that belief, and (3) that the speaker is not aware of any undisclosed facts tending to seriously undermine the accuracy of the statement." *Wells Fargo*, 12 F.3d at 930. To the extent that Anderson alleges that Stac's Prospectus includes affirmative misstatements, it fails to make any showing that any of the implied assertions are inaccurate.

The remaining claims against Stac's Prospectus concern omissions, which are necessarily historical in nature, as companies are not required to predict the future. *WOW*, 35 F.3d at 1420; *VeriFone*, 11 F.3d at 869. Like the prospectus in *Convergent*, the Stac Prospectus neither stints on warnings nor fails to disclose Stac's practices, but "fairly overflows" with specific and detailed cautionary language. *Convergent*, 948 F.2d at 515. We agree with the district court that the Prospectus adequately disclosed the information Anderson alleges Stac to have concealed and that it contained "*enough* cautionary language or risk disclosure that reasonable minds could not disagree that the challenged statements were not misleading." *Fecht*, 70 F.3d at 1082 (citation and quotations omitted). In light of the foregoing, we hold that the district court properly dismissed Anderson's Prospectus-based claims.

B. *Fraud on the Market.*

Anderson argues that Stac committed a "fraud on the market" through its failure to disclose material facts in its Prospectus and other public statements. In such cases, a

"plaintiff claims that he was induced to trade stock not by any particular representations made by corporate insiders, but by the artificial stock price set by the market in light of statements made by the insiders as well as all other material public information." *In re Apple Computer Sec. Litig.*, 886 F.2d 1109, 1114 (9th Cir. 1989), *cert. denied*, 496 U.S. 943 (1990).

To prevail on this theory, a plaintiff "must demonstrate that a particular statement, when read in light of all the information then available to the market, or a failure to disclose particular information, conveyed a false or misleading impression." *Convergent*, 948 F.2d at 512. "If, however, the information that defendants are alleged to have withheld from or misrepresented to the market has entered the market through other channels, the market will not have been misled, and . . . plaintiffs' claims . . . will fail." *Kaplan*, 49 F.3d at 1376 (citations omitted).

As the district court observed, Anderson's fraud on the market claim is undermined by its own pleaded assertions that demand for Stacker had weakened due to "customer resistance to purchasing separate data compression software products in anticipation of the availability of upgraded personal computer operating systems that included data compression capacity."[6] [SAC, ER 45, ¶ 4.]

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[6] In its first amended complaint ("FAC"), Anderson alleged that "the demand for Stacker was being severely diminished by the emergence of competitive products and by anticipation that new software programs to be introduced by market leaders including . . . Microsoft's DOS.6, would include data compression, making Stacker obsolete." [FAC ¶ 43(e); SER 27-28.]

According to the SAC, this weakened demand was known to insiders but not to the public. However, customer resistance to purchasing a product in anticipation of newer products is precisely the sort of market awareness that we have held to defeat claims of fraud on the market. *Convergent*, 948 F.2d at 513. If customers knew that upgraded operating systems were likely to include data compression, the market was aware that Stacker could become obsolete. We have observed that, "[a]s a general matter, investors know of the risk of obsolescence posed by older products forced to compete with more advanced rivals." *Id.* Indeed, "technical obsolescence of computer equipment in a field marked by rapid technological advances is information within the public domain." *Id.* (quotations and alterations omitted).

As discussed above, Stac so cautioned in its Prospectus: "The market for data compression products is characterized by rapidly changing technology, evolving industry standards and frequent new product introductions . . . [which] could render existing products obsolete and unsalable." [Prospectus at 6.] Stac's Prospectus also clearly acknowledges the company's dependence on the Stacker product. [Id. at 5, 24.] Even without such disclosures on the part of Stac, however, investors could easily have predicted that if Stac's key product were to lose its market share, the company would be in serious trouble. *See WOW*, 35 F.3d at 1420 ("[i]t was obvious to any reasonable investor that if either of WOW's two products were to lose favor with consumers, the company would be devastated. . . . " (quotations omitted)). Accordingly, we agree with the district court that Anderson has

failed to allege a Section 10(b) claim for fraud on the market.

C. *Pre-offering statements – roadshows.*[7]

The district court found that Anderson's allegations concerning roadshow presentations were not stated with adequate particularity under Rule 9(b). We agree with the district court's assessment.

Anderson states time, place and content of the roadshows in the broadest of terms, and suggests that Stac officers made positive forecasts to promote the Stac offering. This does not suffice under Rule 9(b) or *GlenFed II*, especially given that Anderson had fourteen months in which to undertake discovery prior to the stay. *See Neubronner v. Milken*, 6 F.3d 666, 671-72 (9th Cir. 1993). We hold that the district court properly dismissed these claims under Rule 9(b).

II

Underwriters' liability.

Anderson alleges that Stac, its outside directors, and other venture capital defendants, schemed with the Underwriters to project false reports following the IPO. But it provides no specific facts – no names, no meetings,

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[7] Anderson does not dispute on appeal the district court's rulings regarding post-offering statements. Accordingly, we deem plaintiffs' arguments concerning such statements waived. *Officers for Justice v. Civil Serv. Comm'n of City & County of San Francisco*, 979 F.2d 721, 726 (9th Cir.1992), *cert. denied*, 507 U.S. 1004 (1993).

no internal memoranda or documents, no specific conduct or statement – in support of its theory. Nor does it explain the disparity in the projections offered by Alex. Brown, which remained positive in its forecast, and by Montgomery, which lowered its rating of Stac after the failure of another computer company.

"In order to be liable for unreasonably disclosed third-party forecasts, defendants must have put their imprimatur, express or implied, on the projections." *In re VeriFone Sec. Litig.*, 784 F. Supp. 1471, 1486 (N.D.Cal. 1992), *aff'd*, 11 F.3d 865 (9th Cir. 1993). The facts must be stated with particularity as required by Fed. R. Civ. P. 9(b). *Id.* at 1486-87. "Plaintiffs must show why the projection disclosed lacked a reasonable basis." *Id.* at 1487. Finally,

> "Issuers need not reveal all projections. Any firm generates a range of estimates internally or through consultants. It may reveal the projection it thinks best while withholding others, so long as the one revealed has a 'reasonable basis' – a question on which other estimates may reflect without automatically depriving the published one of foundation."

Id. (quoting *Wielgos v. Commonwealth Edison Co.*, 892 F.2d 509, 516 (7th Cir. 1989)). Anderson cannot rely on the group published information exception to Rule 9(b) because the SAC contains no allegations that outside directors or underwriters "either participated in the day-to-day corporate activities, or had a special relationship with the corporation, such as participation in preparing or communicating group information at particular times." *GlenFed III*, 60 F.3d at 593.

We agree with the district court that "[b]ecause the group pleading doctrine is not available, and because the roles of the underwriter, outside director, and venture capital defendants in propounding the allegedly fraudulent statements are left unspecified, it follows that Plaintiffs have not met the specificity requirements of Rule 9(b)."

III

Statute of limitations.

The statute of limitations governing Section 11 requires filing a complaint within three years of offer or sale of a security or within one year of actual notice or inquiry notice of an untrue or misleading statement. 15 U.S.C. Sec. 77m. Section 10(b) and Rule 10b-5 complaints must be filed "within one year after the discovery of facts constituting the violation and within three years after such violation." *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350, 364 and n. 9 (1991); 15 U.S.C. § 78i(e).

Anderson filed the SAC one year and four months after the original complaints were filed, naming for the first time the nine new defendants. Anderson contends it did not have enough information earlier to suspect the involvement of the new defendants. Given, however, that plaintiffs were clearly aware of or suspected fraud at the time they filed their first complaint, and given further that all of the new defendants were named in the Prospectus and added to the SAC on the basis of their corporate positions alone, the district court correctly found that plaintiffs had adequate notice. Accordingly, we affirm the

district court's decision to dismiss claims concerning the new defendants.

For the reasons stated above, the district court's opinion is affirmed.

AFFIRMED.

[82 F.3d 1480]

FOR PUBLICATION

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

In re STAC ELECTRONICS SECURITIES LITIGATION	
TIMOTHY J. ANDERSON; NEIL SINGER; ARTHUR SINGER, on Behalf of Themselves and All Others Similarly Situated, *Plaintiffs-Appellants,* v. GARY W. CLOW; DOUGLAS WHITING; ROBERT JOHNSON; ALEX BROWN & SONS INCORPORATED; LAWRENCE FINCH, et al., *Defendants-Appellees.*	No. 94-56232 D.C. No. CV-92-1120-JSR OPINION

Appeal from the United States District Court
for the Southern District of California
John S. Rhoades, District Judge, Presiding

Argued and Submitted
February 6, 1996 – Pasadena, California

Filed May 7, 1996

Before: J. Clifford Wallace, Warren J. Ferguson,
and Thomas G. Nelson, Circuit Judges.

Opinion by Judge T.G. Nelson

COUNSEL

William S. Lerach and Leonard B. Simon, Milberg, Weiss, Bershad, Hynes & Lerach, San Diego, California, for plaintiffs-appellants.

Steven M. Schatz, Wilson, Sonsini, Goodrich & Rosati, Palo Alto, California, and Charlene S. Shimada, McCutchen, Doyle, Brown & Enersen, San Francisco, California, for defendants-appellees.

OPINION

T.G. NELSON, Circuit Judge:

OVERVIEW

Timothy J. Anderson and other class representatives (collectively "Anderson") who purchased stock in Stac Electronics ("Stac") between May 7 and July 20, 1992, appeal the district court's dismissal of their class action under Sections 11 and 15 of the Securities Act of 1933, 15 U.S.C. § 77k, 77o, and Sections 10(b) and 20 of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) and 78t. Anderson alleges that Stac, certain of its officers and directors, and its lead underwriters, Alex. Brown & Sons, Inc., and Montgomery Securities ("Alex. Brown" and "Montgomery," respectively; collectively, "Underwriters"), made material misrepresentations or omissions regarding Stac's initial public offering ("IPO") of May 7, 1992. We have jurisdiction under 28 U.S.C. § 1291, and we affirm.

FACTS AND PROCEDURAL HISTORY

This case arises from Stac's May 7, 1992, IPO of stock in its computer products company. Stac's most prominent product is the "Stacker," a data-compressing device which doubles storage capacity of disk drives in computers using Microsoft's MS-DOS and compatible systems.

The district court related the following facts, which are not disputed by the parties:

> Before it went public, Stac's performance was mixed: it reported net losses per share in 1988, 1989, and 1990, and a net income per share of $.01 in 1991. It also reported revenues hovering around three quarters of a million dollars for 1988 and 1989, with increased revenues in 1990 (to $1.7 million) and 1991 (to $8.3 million).
>
> There was a pronounced move upward – in both revenues and earnings per share – immediately prior to the initial public offering of Stac stock. While Stac reported revenues of $2.3 million and a loss of $.04 per share in the six months prior to March 31, 1991, it reported revenues of $17 million and earnings of $.21 per share in the six months prior to March 31, 1992. The increased revenues and earnings for the 1992 six month period derived from sales of Stacker.
>
> On May 7, 1992, Stac went public, with an initial offering of 3,000,000 shares of common stock. The stock was sold to the public at $12.00 a share, with the individual named Defendants – except for Hoff, Finch and Robelen – selling some 508,000 shares. Neither Hoff, Finch,

> Robelen nor any of the venture capital Defendants is alleged to have sold any Stac stock during the class period [May 7 to July 20, 1992]. Defendants Alex. Brown & Sons, Inc. and Montgomery Securities acted as co-lead underwriters for the offering; they received substantial fees – some $2.5 million – for their services.

In connection with the IPO, Stac issued a Registration Statement and Prospectus ("Prospectus"), dated May 7, 1992, which included a four-page section on risk factors warning investors, *inter alia*, of Stac's competition, its dependence on Stacker, its reliance on distributors, its limited source of supply, and the potential volatility of its stock price. [*See* Prospectus at 5-8.] The Prospectus specifically discussed Microsoft's competitive threat, Stac's return policy and return allowances, and the possible effects on revenues of "channel fill," or heavy purchasing by distributors immediately following the introduction of a new product. [*Id.*]

Apart from the Prospectus, information about Stac was disseminated to the public through "roadshow" presentations preceding the IPO and through analysts' reports and press statements by Stac officers and Underwriters following the IPO. All of these portrayed Stac as a good investment. While these portrayals at first seemed accurate – Stac rose to $15 after the IPO – success was short-lived. Stac's stock price fell on July 2, 1992, on the heels of another computer software company's announcement of poor third quarter results.

Stac Director Gary Clow ("Clow") and both Underwriters made statements to *Dow Jones News Wire* distinguishing Stac from the faltering software company. While

Alex. Brown continued to rate Stac highly, Montgomery reduced its rating and earnings estimate for Stac on July 6, 1992. On July 20, 1992, Stac disclosed a disappointing third quarter performance, and on July 21, 1992, Stac stock declined to $5.50 per share. Within two days, plaintiffs filed suit. This initial suit was consolidated in the First Amended Class Action Complaint ("the FAC"), filed December 4, 1992.

The FAC asserted four claims for relief: I) against all defendants, alleging violation of Section 11 of the Securities Act, 15 U.S.C. § 77k(a); II) against all individual defendants and venture capital defendants, alleging controlling person liability under Section 15 of the Securities Act, 15 U.S.C. § 77o; III) against all defendants, alleging violations of Section 10(b) of the Exchange Act, 15 U.S.C. § 78j(b), and Rule 10(b)(5); of the Securities and Exchange Commission ("SEC"), 17 C.F.R. § 240.10b-5; and IV) against all individual defendants and venture capital defendants, alleging controlling person liability[1] under Section 20(a) of the Exchange Act, 15 U.S.C. § 78t.

The complaint basically alleged that Stac went public knowing (but without disclosing) that Microsoft was about to come out with a competitive product (a new version of DOS incorporating Stacker-like data compression capabilities) that would take away Stac's market; that Stac engaged in sham licensing negotiations with Microsoft in order to stall introduction of its new product until Stac could make an IPO and unload stock; and that

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[1] Plaintiffs on appeal offer no arguments concerning controlling person liability under Section 20 or under Section 15.

Stac insiders artificially inflated Stac's stock price prior to the IPO through channel "stuffing" and other fraudulent practices.

The district court dismissed the FAC with leave to amend in a detailed order dated September 17, 1993. *Anderson v. Clow*, Fed. Sec. L. Rep. (CCH) ¶ 97,807 at 97,994-95 (S.D.Cal. 1993). The district court held that plaintiffs had failed to state a claim against Stac, the Underwriters, or any other named defendant, primarily on the basis of its finding that, to the extent it was required to do so, Stac had adequately disclosed all purported omissions in its Prospectus in a way that rendered the Prospectus not misleading. The order also stayed discovery.

On November 18, 1993, the plaintiffs filed a Second Amended Complaint ("the SAC"), asserting the same claims as the FAC and adding nine new individual defendants. The district court dismissed the SAC with prejudice for failure to state a claim under Fed. R. Civ. P. 12(b)(6) and for failure to meet the particularity requirements of Fed. R. Civ. P. 9(b). *Anderson v. Clow*, Fed. Sec. L. Rep. (CCH) ¶ 98,367 (S.D.Cal. 1994). Like the first order, the order appealed from is extremely thorough. Anderson's appeal was timely.

DISCUSSION

Standard of review.

Dismissal pursuant to Fed. R. Civ. P. 12(b)(6) is reviewed *de novo*. *In re VeriFone Sec. Litig.*, 11 F.3d 865, 868 (9th Cir.1993). "All allegations of material fact are taken as true and construed in the light most favorable to the

plaintiff." *In re Wells Fargo Sec. Litig.*, 12 F.3d 922, 925 (9th Cir.1993), *cert. denied*, 115 S. Ct. 295 (1994). However, "[c]onclusory allegations of law and unwarranted inferences are insufficient to defeat a motion to dismiss for failure to state a claim." *VeriFone*, 11 F.3d at 868.

I

Fraud on the Market.

Anderson argues that Stac committed a "fraud on the market" through its failure to disclose material facts in its Prospectus and other public statements. In such cases, a "plaintiff claims that he was induced to trade stock not by any particular representations made by corporate insiders, but by the artificial stock price set by the market in light of statements made by the insiders as well as all other material public information." *In re Apple Computer Sec. Litig.*, 886 F.2d 1109, 1114 (9th Cir.1989), *cert. denied*, 496 U.S. 943 (1990).

To prevail on this theory, a plaintiff "must demonstrate that a particular statement, when read in light of all the information then available to the market, or a failure to disclose particular information, conveyed a false or misleading impression." *In re Convergent Technologies Sec. Litig.*, 948 F.2d 507, 512 (9th Cir.1991). "If, however, the information that defendants are alleged to have withheld from or misrepresented to the market has entered the market through other channels, the market will not have been misled, and . . . plaintiffs' claims . . . will fail." *Kaplan v. Rose*, 49 F.3d 1363, 1376 (9th Cir.1994) (citations omitted), *cert. denied*, 116 S. Ct. 58 (1995).

As the district court observed, Anderson's fraud on the market claim is undermined by its own pleaded assertions that demand for Stacker had weakened due to "customer resistance to purchasing separate data compression software products in anticipation of the availability of upgraded personal computer operating systems that included data compression capacity."[2] [SAC, ER 45, ¶ 4.] According to the SAC, this weakened demand was known to insiders but not to the public. However, customer resistance to purchasing a product in anticipation of newer products is precisely the sort of market awareness that we have held to defeat claims of fraud on the market. *Convergent*, 948 F.2d at 513. If customers knew that upgraded operating systems were likely to include data compression, the market was aware that Stacker could become obsolete. We have observed that, "[a]s a general matter, investors know of the risk of obsolescence posed by older products forced to compete with more advanced rivals." *Id.* Indeed, "technical obsolescence of computer equipment in a field marked by rapid technological advances is information within the public domain." *Id.* (quotations and alterations omitted).

Stac so cautions in its Prospectus: "The market for data compression products is characterized by rapidly changing technology, evolving industry standards and

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[2] In its first amended complaint ("FAC"), Anderson alleged that "the demand for Stacker was being severely diminished by the emergence of competitive products and by anticipation that new software programs to be introduced by market leaders including . . . Microsoft's DOS.6, would include data compression, making Stacker obsolete." [FAC ¶ 43(e); SER 27-28.]

frequent new product introductions . . . [which] could render existing products obsolete and unsalable." [Prospectus at 6.] Stac's Prospectus also clearly acknowledges the company's dependence on the Stacker product. [Id. at 5, 24.] Even without such disclosures on the part of Stac, however, the adequacy of which we discuss at greater length below, investors could easily have predicted that if Stac's key product were to lose its market share, the company would be in serious trouble. *See In re Worlds of Wonders Sec. Litig.*, 35 F.3d 1407, 1420 (9th Cir.1994) ("WOW") ("[i]t was obvious to any reasonable investor that if either of WOW's two products were to lose favor with consumers, the company would be devastated. . . . " (quotations omitted)), *cert. denied*, 116 S. Ct. 185 (1995) and 116 S. Ct. 277 (1995). Accordingly, we agree with the district court that Anderson has failed to allege a claim for fraud on the market.

II

Securities claims.

Anderson argues that by "falsifying" its financial statements and failing to disclose pertinent information in its possession regarding Microsoft's plans to include data compression in its newest version of DOS, Stac misled investors and violated Section 11 of the Securities Act of 1933, 15 U.S.C. § 77k(a), Section 10(b) of the Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5 of the Securities and Exchange Commission ("SEC"), 17 C.F.R. § 240.10(b)(5). The district court held that the SAC failed to state a claim under Section 11, Section 10(b), or Rule 10b-5. It further held that the SAC failed to plead

with sufficient particularity its Section 10(b) and Rule 10b-5 claims, as required by Fed. R. Civ. P. 9(b). We address the adequacy of Anderson's claims *de novo*. *Veri-Fone*, 11 F.3d at 868.

On appeal, Anderson stresses the following: Stac and its officers: 1) failed to disclose imminent competition from Microsoft and deliberately stalled licensing negotiations with Microsoft in order to delay Microsoft's market entry; and 2) falsified its financial statements by artificially inflating reported results through channel "stuffing," accomplished by offering customers "special terms," including discounts and exceptional rights of return; understating its existing reserves; and failing to disclose Stac's "inevitable" impending decline.

Both Section 11 of the Securities Act and Section 10(b) of the Exchange Act require a plaintiff "adequately [to] allege a material misrepresentation or omission." *Id.* While Section 11 pertains to a company's prospectus alone, Section 10(b) also covers statements made in other documents or in oral communications. Section 11 creates a private remedy for any purchaser of a security if any part of the registration statement,

> when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading. . . .

15 U.S.C. § 77k(a).

Section 10(b) of the Exchange Act of 1934 makes it unlawful "for any person . . . [t]o use or employ, in

connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe." 15 U.S.C. § 78j(b). SEC Rule 10b-5, promulgated under the authority of Section 10(b) provides that:

> It shall be unlawful for any person . . .
>
> > (a) To employ any device, scheme, or artifice to defraud,
> >
> > (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or
> >
> > (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

17 C.F.R. § 240.10(b)(5).

It is well established that claims brought under Rule 10b-5 and Section 10(b) must meet the particularity requirements of Fed. R. Civ. P. 9(b). *Wool v. Tandem Computers, Inc.*, 818 F.2d 1433, 1439 (9th Cir.1987). Rule 9(b) states that, "[i]n all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity. Malice, intent, knowledge, and other condition of mind of a person may be averred generally."

Anderson disputes, however, the applicability of Rule 9(b) to its Section 11 claims. The district court considered plaintiffs' Section 11 and Section 10(b) claims separately, dismissing the former under Rule 12(b)(6) and the latter under Rule 9(b), though it applied similar standards and reasoning to each. We recently affirmed a district court's dismissal of 1933 and 1934 Act claims, including Section 11 claims, for failure to satisfy Fed. R. Civ. P. 9(b). *In re GlenFed, Inc. Sec. Litig.*, 60 F.3d 591, 592 (9th Cir.1995) ("*GlenFed III*") (on remand from en banc decision, 42 F.3d 1541 (9th Cir.1994)). We now clarify that the particularity requirements of Rule 9(b) apply to claims brought under Section 11 when, as here, they are grounded in fraud rather than negligence.[3] *See Melder v. Morris*, 27 F.3d 1097, 1100 n.6 (5th Cir.1994) (citing *Shapiro v. UJB Fin. Corp.*, 964 F.2d 272, 287-89 (3d Cir.), *cert. denied*, 113 S. Ct. 365 (1992); *Sears v. Likens*, 912 F.2d 889, 892-93 (7th Cir.1990)). Rule 9(b) serves to give defendants adequate notice to allow them to defend against the charge and to deter the filing of complaints "as a pretext for the discovery of unknown wrongs," to protect professionals from the harm that comes from being subject to fraud charges, and to "prohibit [ ] plaintiff[s] from unilaterally imposing upon the court, the parties and society enormous social and economic costs absent some factual basis." *Semegen v. Weidner*, 780 F.2d 727, 731 (9th Cir.1985).

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[3] Anderson argues that it specifically disclaimed any allegations of fraud with respect to its Section 11 claims. These nominal efforts are unconvincing where no effort is made to show negligence on Stac's part and the gravamen of the complaint is plainly fraud.

The same policy considerations apply to Section 11 claims sounding in fraud.

We closely examined the role of Rule 9(b) in the securities law context in our recent en banc decision *In re GlenFed, Inc. Sec. Litig.*, 42 F.3d 1541 (9th Cir.1994) (en banc) (*"GlenFed II "*). With respect to scienter, we held that plaintiffs need only "say[ ] [it] existed." *Id.* at 1547. However, we went on to hold that plaintiffs "must aver with particularity the circumstances constituting the fraud." *Id.* We explained that time, place and content allegations, while necessary, are insufficient by themselves to state a claim for fraud. *Id.* at 1547-48. "The plaintiff must set forth what is false or misleading about a statement, and why it is false. In other words, the plaintiff must set forth an explanation as to why the statement or omission complained of was false or misleading." *Id.* at 1548. Further, the statement or omission must be shown to have been false or misleading *when made.* Id. at 1548-49.

We agree with Anderson that our clarification of the scienter requirement in *GlenFed II* nullifies the district court's conclusion that Anderson's claims must fail because Anderson did not plead scienter with particularity. The SAC sufficiently avers fraudulent intent on the part of Stac and its officers for the purpose of Rule 9(b). However, the remainder of our decision in *GlenFed II* supports the conclusion that Anderson's claims must nevertheless fail if, as the district court found, Anderson failed to plead the underlying fraud with particularity. [See ER 80 at 16-31, 39, 45.]

A. *Stac's Prospectus.*

The district court devoted much of its order to consideration of Stac's Prospectus.[4] The court found that the alleged omissions were either actually disclosed, or need not have been disclosed, in that document. The "materiality" of an omission is a fact-specific determination that should ordinarily be assessed by a jury. *Fecht v. The Price Co.*, 70 F.3d 1078, 1080-81 (9th Cir.1995), *pet. for cert. denied*, 64 USLW 3593 (Feb. 20, 1996) (No. 95-1347). "[O]nly if the adequacy of the disclosure or the materiality of the statement is so obvious that reasonable minds could not differ are these issues appropriately resolved as a matter of law." *Id.* at 1081 (quotations and alterations omitted).

1. *Microsoft's plans to include data compression.*

The gravamen of Anderson's complaint concerns Stac's alleged failure to disclose its knowledge of Microsoft's plans to introduce data compression in its upcoming version of DOS. According to Anderson, Stac entered

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[4] The district court considered the full text of the Prospectus, including portions which were not mentioned in the complaints. We note that such consideration is appropriate in the context of a motion to dismiss, and does not convert the motion into one for summary judgment. " '[D]ocuments whose contents are alleged in a complaint and whose authenticity no party questions, but which are not physically attached to the pleading, may be considered in ruling on a Rule 12(b)(6) motion to dismiss.' " *Fecht v. The Price Co.*, 70 F.3d 1078, 1080 n.1 (9th Cir.1995) (quoting *Branch v. Tunnell*, 14 F.3d 449, 454 (9th Cir.), *cert. denied*, 114 S.Ct. 2704 (1994)), *pet. for. cert. filed*, 64 USLW 3593 (Feb. 20, 1996) (No. 95-1347).

into "sham" licensing negotiations with Microsoft merely to stall Microsoft's introduction of its new product. In the SAC, Anderson also alleged that Stac's patents were inadequate to prevent others from using its technology to create competitive products. Prior to the district court's ruling, however, Stac won a $120 million judgment against Microsoft for patent infringement relating to Stacker. *See Stac Electronics v. Microsoft Corp.*, Civil No. 93-0413-ER (Bx) (C.D.Cal. Feb. 23, 1994). The district court properly took judicial notice of this judgment in determining that the proprietary and patent information provided in the Prospectus was not misleading. [ER 80 at 17.] Anderson does not raise the patent issue on appeal.

Regarding the threat of Microsoft "looming," the district court correctly observed that the Prospectus makes detailed disclosures concerning the risk of competition. For instance, the Prospectus states that "[a] number of competitors offer products that currently compete with [Stac's] products" and that these companies "could seek to expand their product offerings by designing and selling products using data compression or other technology that could render obsolete or adversely affect sales of [Stac's] products." [Prospectus at 5.] After noting Stac's dependence on sales of DOS-compatible products, the Prospectus observes that:

> One developer of a compatible operating system has licensed a competitive data compression product for incorporation into the latest version of the operating system. *There can be no assurance that Microsoft . . . will not incorporate a competitive data compression technology* in their products or that such a technology will not emerge as an industry standard.

[*Id.* (emphasis added).] Further, the Prospectus reveals that "[Stac] has licensed and intends to license portions of its core technology to others," a practice which it cautions could result in more competition and price reductions. [*Id.*]

Anderson alleges that the "no assurance" language is inadequate and that Stac committed fraud because it *knew* that Microsoft was going to come out with a competitive product, but masked this knowledge as a contingency. Anderson quotes repeatedly the following statement: " 'To warn that the untoward may occur when the event is contingent is prudent; to caution that it is only possible for the unfavorable events to happen when they have already occurred is deceit.' " *Convergent*, 948 F.2d at 515 (quoting *Huddleston v. Herman & MacLean*, 640 F.2d 534, 544 (5th Cir.1981), *aff'd in relevant part and rev'd in part on other grounds*, 459 U.S. 375 (1983)).

We have rephrased this principle as follows: " 'There is a difference between knowing that any product-in-development may run into a few snags, and knowing that a particular product has already developed problems so significant as to require months of delay.' " *Id.* (quoting *Apple Computer*, 886 F.2d at 1115). The latter scenario characterizes the situation we encountered in *Warshaw v. Xoma Corp.*, 74 F.3d 955 (9th Cir.1996). Corporate officers of Xoma, a biotech company which had yet to make a profit on its research, assured stockholders that FDA approval of its new drug was imminent, in spite of knowledge that the drug might not work and was unlikely to receive such approval. *Id.* at 957-59.

Anderson has not alleged any such contradictory statements here. In Convergent, we proceeded to distinguish the case before us from the Fifth Circuit case quoted, noting that Convergent's prospectus "virtually overflow[ed]" with risk factors, and to hold that the defendant company was not obliged to disclose its internal projections because such projections are tentative. 948 F.2d at 515-16. We cited as adequate multiple warnings in the Convergent prospectus stating that "there is no assurance" of financial success given a variety of named obstacles to production. *Id.* We therefore cannot agree with Anderson's characterization of Stac's "no assurance" language as "misleading" or inadequate.

Anderson argues that Stac should have explicitly disclosed its ongoing negotiations with Microsoft and its knowledge that Microsoft intended to introduce data compression technology in its new version of DOS. In short, Anderson suggests that Stac was obliged not only to report on its own product line and marketing plans, but to report on and make predictions regarding *Microsoft's* intentions.

Stac counters, and we have held, that a company is not required to forecast future events or to caution "that future prospects [may not be] as bright as past performance." *WOW*, 35 F.3d at 1420 (" 'Absent allegations that [the issuer] withheld financial data or other existing facts from which forecasts are typically derived, the alleged omissions are not of material, actual facts. Therefore, the forecasts need not have been disclosed, and the failure to make the omitted forecasts did not render the other statements that were made misleading.' ") (quoting *VeriFone*, 11 F.3d at 869).

We agree with Stac that another company's plans cannot be known to a certainty. Even assuming, as we must, that Microsoft had informed Stac that it planned to introduce data compression, Stac could not have known whether or not Microsoft would truly do so. As Stac points out, the contingency of the event is underscored by the fact that a competitive product was liable to violate Stacker's patent, as borne out by the state judgment against Microsoft. Also, the market already knew of the potential for Microsoft's inclusion of data compression technology, as alleged by Anderson in the FAC. *See* footnote 2, *supra*.

2. *Stac's financial statements.*

Anderson also argues that Stac falsified its financial statements in the Prospectus by failing to disclose its channel-"stuffing" practices, its inadequate reserves, and its liberal distribution terms, all of which Anderson characterizes as illegitimate "borrowing" against the future to inflate its returns in the quarter prior to the public offering.

As the district court found, however, the Prospectus describes the phenomenon of channel-filling with its attendant risks, spells out Stac's liberal return policy, warns investors of Stac's exposure to the risk of product returns, and advises investors not to predict future returns on the basis of the results of any single quarter. The following excerpts from the Prospectus are instructive.

a. Channel fill:

The Company's results of operation are subject to significant quarterly variations as a result of a number of factors and risks, including . . . the phenomenon of "channel fill". . . . Channel fill often occurs following the introduction of a new product or a new version of a product as distributors buy significant quantities of a new product or version in anticipation of sales of such product or version. Following such purchases, the rate of distributor's purchases may decline.

[Prospectus at 16.]

b. Return policy, risk of returns, and return allowances:

During the first six months of fiscal 1992 the Company's distributors and software reseller returned substantial quantities of the initial version of Stacker in exchange for version 2.0 of Stacker. Such returns did not materially impact operating results for the first six months of 1992, however, as allowances for returns of the initial version of Stacker had been established in fiscal 1991.

* * *

Like other manufacturers of packaged software products, the Company is exposed to the risk of product returns from distributors and direct reseller customers.

[*Id.* at 6-7.]

The Company's return policy allows its distributors to return any new, unused product in the distributor's inventory within . . . 60 days from the notice of discontinuance of any product, or

> any version of a product, for a credit or cash refund. Although the Company believes that it provides adequate allowances for returns, there can be no assurance that actual returns in excess of recorded allowances will not result in a material adverse effect on business, operating results and financial condition.

[*Id.* at 22.]

> c. Quarterly results:
>
> The Company has historically experienced significant fluctuations in its operating results, including net income, and anticipates that these fluctuations will continue. The Company operates with relatively little backlog, and the majority of its revenues in each quarter results form [sic] orders received in that quarter. Consequently, if near-term demand for the Company's product weakens in a given quarter, the Company's operating results for that quarter would be adversely affected. . . . As a result, the Company believes that period-to-period comparisons of its operating results should not be relied upon as an indication of future performance.

[*Id.* at 6. *See also id.* at 15, 17.]

The parties dispute whether, as a matter of law, these statements can be said to disclose purported omissions and adequately caution investors as to specific risks. We have recognized that the "bespeaks caution" doctrine " 'provides a mechanism by which a court can rule as a matter of law that defendants' forward-looking representations contained enough cautionary language or risk disclosure to protect the defendant against claims of securities fraud.' " *Fecht*, 70 F.3d at 1081 (quoting *WCW*, 35

F.3d at 1413) (alterations omitted).[5] The doctrine serves to "minimize the chance that a plaintiff with a largely groundless claim will bring a suit and conduct extensive discovery in the hopes of obtaining an increased settlement." *WOW*, 35 F.3d at 1415 (quotations omitted).

However, "[i]nclusion of *some* cautionary language is not enough to support a determination as a matter of law that defendants' statements were not misleading." *Fecht*, 70 F.3d at 1082 (emphasis added). "A motion to dismiss for failure to state a claim will succeed only when the statements containing defendants' challenged documents include *enough* cautionary language or risk disclosure that reasonable minds could not disagree that the challenged statements were not misleading." *Id.* (citation and quotations omitted).

The district court did not rely on the bespeaks caution doctrine here because it found that the Prospectus contained no forward-looking representations. [SER 37:23.] By definition, the bespeaks caution doctrine applies only to affirmative, forward-looking statements. *Id.* at 1413 n.2. However, we have observed that the doctrine "merely represents the pragmatic application of two fundamental concepts in the law of securities fraud: materiality and reliance." *WOW*, 35 F.3d at 1414.

> [T]he 'bespeaks caution' doctrine has developed to address situations in which optimistic projections are coupled with cautionary language . . . affecting the reasonableness of

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[5] The bespeaks caution doctrine applies to both Section 10(b) and Section 11 claims. *WOW*, 35 F.3d at 1415 n.3.

> reliance on and the materiality of those projections. To put it another way, the 'bespeaks caution' doctrine reflects the unremarkable proposition that statements must be analyzed in context.

Id. (quoting *Rubinstein v. Collins*, 20 F.3d 160, 167 (5th Cir.1994)). In *WOW*, we approved the district court's application of the "*Basic* test of materiality" to plaintiffs' claims concerning material omissions, which states that for nondisclosure to be actionable, " 'there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.' " *Id.* at 1413 n.2 (quoting *Basic Inc. v. Levinson*, 485 U.S. 224, 231-31 (1988)) (alterations omitted).

Here, Anderson characterizes certain claims regarding Stac's Prospectus as both material omissions and misstatements. For example, Anderson alleges that Stac failed to disclose its inadequate reserves for returns. At the same time, Anderson characterizes the Prospectus's statement that "the Company believes it provides adequate allowances for returns" as an affirmative misstatement. The quoted sentence reads in full: "Although the Company believes it provides adequate allowances for returns, there can be no assurance that actual returns in excess of recorded allowances will not result in a material adverse effect on business, operating results, and financial condition." [Prospectus at 7.]

Anderson further charges that Stac attributes its increase in revenues in the second quarter of 1992 to awards and favorable reviews, when in fact the increase

was due to channel-fill, or what Anderson terms channel-"stuffing." In fact, Stac's conjecture that the 1992 increases were due "partially" to awards and reviews appears in the context of a section on "quarterly trends" which leads off with an explanatory and cautionary statement about the effects of channel fill on revenue. [Prospectus at 16-17.] Analyzing the quoted statements in context leads to the inexorable conclusion that investors were specifically and adequately cautioned about the relevant risks. Insofar as Stac's alleged misstatements can be viewed as "optimistic projections," they are more than adequately covered by the bespeaks caution doctrine.

Bespeaks caution aside, Anderson fails to make precise allegations explaining how the alleged misstatements were misleading or untrue when made. "The plaintiff must set forth what is false or misleading about a statement, and why it is false. In other words, the plaintiff must set forth an explanation as to why the statement or omission complained of was false or misleading." *GlenFed II*, 42 F.3d at 1548. Statements which imply factual assertions are actionable if any one of the following statements is inaccurate: "(1) that the statement is genuinely believed, (2) that there is a reasonable basis for that belief, and (3) that the speaker is not aware of any undisclosed facts tending to seriously undermine the accuracy of the statement." *In re Wells Fargo Sec. Litig.*, 12 F.3d 922, 930 (9th Cir.1993), *cert. denied*, 115 S. Ct. 295 (1994). To the extent that Anderson alleges that Stac's Prospectus includes affirmative misstatements, it fails to make any showing that any of the implied assertions are inaccurate.

The remaining claims against Stac's Prospectus concern omissions, which are necessarily historical in nature,

as companies are not required to predict the future. *WOW*, 35 F.3d at 1420; *VeriFone*, 11 F.3d at 869. Like the prospectus in *Convergent*, the Stac Prospectus neither stints on warnings nor fails to disclose Stac's practices, but "fairly overflows" with specific and detailed cautionary language. *Convergent*, 948 F.2d at 515. We agree with the district court that the Prospectus adequately disclosed the information Anderson alleges Stac to have concealed and that it contained "*enough* cautionary language or risk disclosure that reasonable minds could not disagree that the challenged statements were not misleading." *Fecht*, 70 F.3d at 1082 (citation and quotations omitted). In light of the foregoing, we hold that the district court properly dismissed Anderson's Prospectus-based claims.

B. *Pre-offering statements – roadshows.*[6]

The district court found that Anderson's allegations concerning roadshow presentations were not stated with adequate particularity under Rule 9(b). We agree with the district court's assessment of the roadshow allegations.

Anderson states time, place and content of the roadshows in the broadest of terms, and suggests that Stac officers made positive forecasts to promote the Stac offering. This does not suffice under Rule 9(b) or *GlenFed II*, especially given that Anderson had fourteen months in

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[6] Anderson does not dispute on appeal the district court's rulings regarding post-offering statements. Accordingly, we deem plaintiffs' arguments concerning such statements waived. *Officers for Justice v. Civil Serv. Comm'n of City & County of San Francisco*, 979 F.2d 721, 726 (9th Cir.1992), *cert. denied*, 507 U.S. 1004 (1993).

which to undertake discovery prior to the stay. *See Neubronner v. Milken*, 6 F.3d 666, 671-72 (9th Cir.1993). We hold that the district court properly dismissed these claims under Rule 9(b).

III

Underwriters' liability.

Anderson alleges that Stac, its outside directors, and other venture capital defendants, schemed with the Underwriters to project false reports following the IPO. But it provides no specific facts – no names, no meetings, no internal memoranda or documents, no specific conduct or statement – in support of its theory. Nor does it explain the disparity in the projections offered by Alex. Brown, which remained positive in its forecast, and by Montgomery, which lowered its rating of Stac after the failure of another computer company.

"In order to be liable for unreasonably disclosed third-party forecasts, defendants must have put their imprimatur, express or implied, on the projections." *In re VeriFone Sec. Litig.*, 784 F.Supp. 1471, 1486 (N.D.Cal. 1992), *aff'd*, 11 F.3d 865 (9th Cir.1993). The facts must be stated with particularity as required by Fed. R. Civ. P. 9(b). *Id.* at 1486-87. "Plaintiffs must show why the projection disclosed lacked a reasonable basis." *Id.* at 1487. Finally,

> "Issuers need not reveal all projections. Any firm generates a range of estimates internally or through consultants. It may reveal the projection it thinks best while withholding others, so long as the one revealed has a 'reasonable basis' – a question on which other estimates may reflect

> without automatically depriving the published one of foundation."

Id. (quoting *Wielgos v. Commonwealth Edison Co.*, 892 F.2d 509, 516 (7th Cir.1989)). Anderson cannot rely on the group published information exception to Rule 9(b) because the SAC contains no allegations that outside directors or underwriters "either participated in the day-to-day corporate activities, or had a special relationship with the corporation, such as participation in preparing or communicating group information at particular times." *GlenFed III*, 60 F.3d at 593.

We agree with the district court that "[b]ecause the group pleading doctrine is not available, and because the roles of the underwriter, outside director, and venture capital defendants in propounding the allegedly fraudulent statements are left unspecified, it follows that Plaintiffs have not met the specificity requirements of Rule 9(b)."

IV

Statute of limitations.

The statute of limitations governing Section 11 requires filing a complaint within three years of offer or sale of a security or within one year of actual notice or inquiry notice of an untrue or misleading statement. 15 U.S.C. § 77m. This section also governs Section 10(b). *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350 (1991).

Anderson filed the SAC one year and four months after the original complaints were filed, naming for the first time the nine new defendants. Anderson contends it

did not have enough information earlier to suspect the involvement of the new defendants. Given, however, that plaintiffs were clearly aware of or suspected fraud at the time they filed their first complaint, and given further that all of the new defendants were named in the Prospectus and added to the SAC on the basis of their corporate positions alone, the district court correctly found that plaintiffs had adequate notice. Accordingly, we affirm the district court's decision to dismiss claims concerning the new defendants.

For the reasons stated above, the district court's opinion is affirmed.

AFFIRMED.

UNITED STATES DISTRICT COURT

Southern District of California

TIMOTHY J ANDERSON et al

V.

GARY W CLOW et al

JUDGMENT IN A CIVIL CASE

(Filed Jul. 11, 1994)

CASE NUMBER: 92-1120-R(BTM)

[ ] **Jury Verdict.** This action came before the Court for a trial by jury. The issues have been tried and the jury has rendered its verdict.

[X] **Decision by Court.** This action came to trial or hearing before the Court. The issues have been tried or heard and a decision has been rendered.

IT IS ORDERED AND ADJUDGED

THAT DEFENDANTS' MOTIONS TO DISMISS ARE GRANTED; PLAINTIFF'S COMPLAINT IS DISMISSED WITH PREJUDICE. . . .

7/11/94
Date

ROBERTA WESTDAL
Clerk

R.C. JUSTICE
(By) Deputy Clerk

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF CALIFORNIA

TIMOTHY J. ANDERSON, NEIL SINGER, and ARTHUR SINGER, on Behalf of Themselves and All Others similarly Situated, Plaintiffs, v. GARY W. CLOW, DOUGLAS L. WHITING, ROBERT W. JOHNSON, ARTHUR J. COLLMEYER, JOHN R. WITZEL, ROBERT A. HOFF, CROSSPOINT VENTURE PARTNERS, LAWRENCE G. FINCH, SIGMA MANAGEMENT, SIGMA MANAGEMENT II, L.P., SIGMA PARTNERS, RUSSELL J. ROBELEN, IDANTA PARTNERS, STAC ELECTRONICS, ALEX. BROWN & SONS, INC. and MONTGOMERY SECURITIES Defendants. In re STAC ELECTRONICS SECURITIES LITIGATION	CIVIL NO. 92-1120-R ORDER GRANTING DEFENDANTS' MOTION TO DISMISS (Filed June 30, 1994)

Plaintiffs brought the instant class action suit for violations of the securities laws. This Court dismissed the first complaint – the Consolidated Amended Class Action

Complaint (FAC) – on September 17, 1993. This Order concerns the Second Amended Complaint (SAC).

The SAC asserts four claims for relief. Claim I, against all Defendants, is for violation of Section 11 of the Securities Act. Claim II, against all individual Defendants and the venture capital Defendants,[1] charges controlling person liability under Section 15 of the Securities Act. Claim III, against all Defendants, is for violation of Section 10(b) of the Exchange Act and Rule 10b-5 of the Securities and Exchange Commission. Claim IV, against all individual Defendants and the venture capital Defendants, charges controlling person liability under Section 20(a) of the Exchange Act.

The Complaint also alleges conspiracy, aiding and abetting, and "concerted action" to commit the 10b-5 violations.[2]

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[1] The venture capital Defendants are Crosspoint Venture Partners, Sigma Management, Sigma Management II, L.P., Sigma Partners, and Idanta Partners.

When necessary, this Order categorizes Defendants other than Stac as follows: the individual named Defendants, of which there are two groups, the inside director group (Clow, Whiting, and Witzel), and the outside director group (Johnson, Collmeyer, Hoff, Finch, and Robelen); the underwriter Defendants (Alex. Brown and Montgomery Securities); and the venture capital Defendants.

[2] This Court previously noted that the prevailing view is that there is no secondary liability for Section 11 claims; therefore those claims were dismissed from the FAC. *Anderson v. Clow*, Fed. Sec. L. Rep. (CCH) ¶ 97,807 at 97,994-95 (S.D. Cal. 1993).

Defendants move to dismiss the Complaint, on several grounds.[3]

This Court agrees with Defendants, and grants their motion to dismiss, with prejudice.

I. Background

A. Parties

At the time of the events giving rise to this lawsuit, Defendants Clow, Whiting, Johnson, and Collmeyer were

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[3] In its previous opposition papers, Plaintiffs had requested this Court to take judicial notice of the Answer of Microsoft Corporation and Amended Counterclaim in *Stac Electronics v. Microsoft Corp.*, Civ. No. C-93-0413-LGB(GHKx), filed April 5, 1993.

That request was denied. This Court observed that a motion to dismiss is decided on the pleadings.

There are, however, certain exceptions. One exception-noted both here and in the September 17, 1993 Order – is where the pleadings include documents incorporated by reference into the complaint.

Another exception concerns matters of public record. *See Mack v. South Bay Beer Distributors, Inc.*, 798 F.2d 1279, 1282 (9th Cir. 1986) ("on a motion to dismiss a court may properly look beyond the complaint to matters of public record and doing so does not convert a Rule 12(b)(6) motion to one for summary judgment").

While the Answer of Microsoft Corporation and Amended Counterclaim is a matter of public record, to have considered that particular document in the September 17, 1993 Order would have been to take as true not only the allegations of the Complaint in the *instant case*, but also the allegations of the Counterclaim in the *Microsoft case* as well.

Therefore Plaintiffs' request was denied.

officers or directors of Stac Electronics. Clow was Chairman of the Board and Chief Executive Officer; Whiting was Vice President of Technology and a director; Johnson and Collmeyer were directors. SAC at ¶ 23.

The Consolidated Amended Complaint (FAC) had named the above Defendants, in addition to Stac and underwriters Alex. Brown & Sons, Inc. and Montgomery Securities. The latter two Defendants acted as co-lead underwriters for the initial public offering of Stac stock.

The Second Amended Complaint (SAC at ¶ 23) names nine new Defendants: one of Stac's officers, three of its outside directors, and five venture capital investors.

Defendant Witzel was Stac's Vice President of Finance and Operations and Chief Financial Officer. Defendants Finch, Hoff, and Robelen were directors of Stac, as well as occupying additional roles with the venture capital Defendants.

Finch, for instance, was general partner of Defendants Sigma Management and Sigma Management II, L.P. Defendants Sigma Management and Sigma Management II were general partners, in turn, of Defendant Sigma Partners. It is further alleged that Defendant Sigma Partners was a controlling shareholder and person of Defendants Stac and Finch, by virtue of Sigma Partners' ownership of 14.8% of Stac's stock.

Defendant Hoff was general partner of Defendant Crosspoint Venture Partners. It is alleged that Defendant Crosspoint Venture Partners was a controlling shareholder and person of Defendants Stac and Hoff, by virtue

of Crosspoint Venture Partners' ownership of 20.4% of Stac's stock.

Defendant Robelen was a general partner of Defendant Idanta Partners. It is alleged that Defendant Idanta Partners was a controlling shareholder and person of Stac and Robelen, by virtue of Idanta Partners' ownership of 11.2% of Stac's stock.

B. Facts

The facts are, in their essentials, similar to the FAC.

As discussed in this Court's September 17, 1993 Order, Stac produces computer products. In particular, it sells a device – the aptly named Stacker – which compresses computer data. SAC at ¶ 1. Compression increases a computer's capacity for storing data. *Id.*

Before it went public, Stac's performance was mixed: it reported net losses per share in 1988, 1989, and 1990, and a net income per share of $.01 in 1991. It also reported revenues hovering around three quarters of a million dollars for 1988 and 1989, with increased revenues in 1990 (to $1.7 million) and 1991 (to $8.3 million). Prospectus at 3.[4]

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[4] This Court can look to the Prospectus because it is referred to and quoted extensively by Plaintiffs in their Complaint. Therefore it can be treated as part of the pleadings for purposes of a motion to dismiss. *Townsend v. Columbia Operations*, 667 F.2d 844, 848 (9th Cir. 1982); *In re Seagate*

There was a pronounced move upward – in both revenues and earnings per share – immediately prior to the initial public offering of Stac stock. While Stac reported revenues of $2.3 million and a loss of $.04 per share in the six months prior to March 31, 1991, it reported revenues of $17 million and earnings of $.21 per share in the six months prior to March 31, 1992. SAC at ¶ 47. The increased revenues and earnings for the 1992 six month period derived from sales of Stacker. SAC at ¶ 36-37.

On May 7, 1992, Stac went public, with an initial offering of 3,000,000 shares of common stock. The stock was sold to the public at $12.00 a share, with the individual named Defendants – except for Hoff, Finch, and Robelen – selling some 508,000 shares. SAC ¶¶ 23(a)-(e), 45. Neither Hoff, Finch, Robelen nor any of the venture capital Defendants is alleged to have sold any Stac stock during the class period. Defendants Alex. Brown & Sons, Inc. and Montgomery Securities acted as co-lead underwriters for the offering; they received substantial fees-some $2.5 million – for their services. SAC at ¶ 28.

Technology II Sec. Litig. [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,502 at 93,201 (N.D. Cal. May 3, 1989).

Similarly, because Plaintiffs' Complaint refers to and quotes the analysts' reports of the underwriter Defendants, this Court can treat those documents as part of the pleadings for the purposes of the motion to dismiss. *In re Sun Microsystems, Inc. Securities Litigation* [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,504, at 97,636 (N.D. Cal. Aug. 20, 1990).

In connection with the initial public offering, Stack issued a registration Statement and Prospectus ("Prospectus"), dated May 7, 1992. In addition to the financial information noted above, the Prospectus contained extensive discussion of the risks which Stac posed to investors, as well as the competitive environment Stac faced. The Prospectus also discussed Stac's policies concerning distributors, product returns, and allowances for reserves to cover those returns.

The public received statements about Stac from sources other than the Prospectus. Plaintiffs allege that Clow and Witzel made "roadshow" presentations, where they projected increased revenues and earnings in the second half of 1992. SAC at ¶¶ 42-44. Similarly, Plaintiffs allege that, following the initial public offering, various analysts' reports portrayed Stac as a good investment. SAC at ¶¶ 61-68.[5]

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[5] These reports included a June 2, 1992 report from Alex. Brown and a June 2, 1992 report from Montgomery. SAC at ¶¶ 62, 63.

The SAC alleges that the Alex. Brown report projected revenues of $43.5 million and earnings of $.55 per share for Stac in fiscal 1992. These projections included revenues of $12 million and earnings of $.15 per share for the quarter ended June 30, 1992, and revenues of $14.5 million and earnings of $.18 per share for the quarter ended September 30, 1992. SAC at ¶ 62.

Similarly, the SAC alleges that Montgomery projected earnings of $.55 per share for Stac in fiscal 1992, with revenues of $13 million and earnings of $.16 per share for the third quarter of 1992. SAC at ¶ 63.

The SAC also alleges: that the reports were issued pursuant to an agreement between Stac and its officers and the underwriters; that the agreement was favorable reporting in

For a short time, those portrayals seemed accurate. Following the offering, Stac climbed to $15 per share. SAC at ¶ 66. But Stac could not maintain that price per share. On July 2, 1992, on the heels of another computer software company's announcement of poor third quarter results, Stac's stock price fell. Clow, Montgomery, and Alex. Brown, however, all made statements to *Dow Jones News Wire* distinguishing Stac from the other, faltering computer software company. SAC at ¶ 66.

Despite these comments, Montgomery reduced its stock rating and earnings estimate for Stac on July 6, 1992. It attributed Stac's lag to a slowdown in PC software sales and further stated that Stac had not stuffed its distribution channel. SAC at ¶ 67.

In contrast to Montgomery, Alex. Brown did not reduce its rating of Stac: it maintained its strong buy recommendation and current estimates of future earnings. SAC at ¶ 68. The SAC alleges that Stac and its officers adopted the latter report. *Id.*

On July 20, 1992, Stac disclosed its third quarter performance. It was disappointing, at least compared to

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exchange for selection as underwriters; that the information contained in these reports was obtained from Stac or based on information obtained from Stac; and that copies of drafts of these reports were provided to Stac before they were released. SAC at ¶ 65. Plaintiffs also allege that, because Stac and its officers knew of the contents of these reports, they knew that the reports would affect the price of Stac stock; therefore, the SAC alleges, Stac and its officers adopted these reports as their own. *Id.*

earlier projections. On July 21, 1992, Stac stock declined to $5.50 per share. SAC at ¶ 69.

Within two days, there was a lawsuit: Plaintiffs filed the first of their claims later consolidated in the instant action.

Plaintiffs filed their Consolidated Amended Class Action Complaint on December 4, 1992. Both the individual named Defendants and the underwriter Defendants filed motions to dismiss on February 8, 1993.

C. September 17, 1993 Order

By Order dated September 17, 1993, this Court dismissed Plaintiffs' FAC. *Anderson v. Clow*, Fed. Sec. L. Rep. (CCH) ¶ 97,807 at 97,994-95 (S.D. Cal. 1993). In particular, this Court examined the Prospectus and found either that the Prospectus disclosed purported omissions, in a way that made the Prospectus's statements not misleading, or that Stac was not required to make the disclosures. It also found that the allegation of untrue financial statements was a mere summary of the purported omissions, which themselves were found to be disclosed. Hence, the Section 11 count was dismissed in its entirety. The Section 15 – or controlling person – count was also dismissed, since there was no longer an underlying Section 11 count.

This Court also dismissed the 10b-5 count, for various failings. Again, the Section 20 count failed as well, since there was no longer an underlying 10b-5 count. Finally, the conspiracy and aiding and abetting claims were dismissed, in large part because there was no longer

an underlying primary wrong.[6] Finally, the Order also stayed discovery.

Plaintiffs filed a Second Amended Complaint on November 18, 1993. Defendants filed motions to dismiss on January 14, 1994.

II. Applicable Law in Motions to Dismiss

On a motion to dismiss for failure to state a claim upon which relief can be granted under Rule 12(b)(6), the complaint is construed in the light most favorable to the plaintiff, and its allegations are taken as true. *Jenkins v. McKeithen*, 395 U.S. 411, 421-22 (1969); *McKinney v. De Bord*, 507 F.2d 501, 503 (9th Cir. 1974). In reviewing a complaint, a court should let the claims stand "unless it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief." *Conley v. Gibson*, 355 U.S. 41, 45 (1957).

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[6] Since this Court's Order, there have been four important Ninth Circuit decisions concerning motions to dismiss in securities fraud cases. *In re GlenFed. Inc. Securities Litigation*, 11 F.3d 843 (9th Cir. 1993), *rehearing en banc granted* (Feb. 25, 1994) (affirming dismissal); *Neubronner v. Milken*, 6 F.3d 666 (9th Cir. 1993) (affirming dismisssal); *In re Verifone Securities Litigation*, 11 F.3d 865 (9th Cir. 1993) (affirming dismissal); and *In re Wells Fargo Securities Litigation*, 12 F.3d 922 (9th Cir. 1993) (reversing dismissal).

III. Discussion

A. Plaintiffs' Allegations

Plaintiffs' allegations are not conveniently summarized. Instead, they are stated, and restated, and restated yet again, seemingly *ad infinitum*.[7]

In essence, Plaintiffs aver that the Prospectus and the roadshow presentations, analysts' reports, and statements in investment publications were misleading because they failed to disclose several key facts. These facts were:

> 1. That Stac's business was being or would be undermined by new competitive data compression products, imminent competition from software giant Microsoft, and inadequate proprietary protection of Stac's products. SAC at ¶ 4.
>
> 2. That Stac knew that Microsoft intended to enter the data compression field. Worse still, Stac purposefully stalled negotiations with Microsoft over licensing Stac technology. The purpose was to delay Microsoft's entrance beyond the date of the IPO. SAC at ¶ 5.
>
> 3. That Stac's insiders artificially inflated Stac's reported results for the period immediately preceding the IPO. Stac allegedly offered customers

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[7] *See* SAC at ¶¶ 4-6, 44, 49, 51, 53, 56, 57, 58, 59, 60, 64, 66, 67, 68; *see also* ¶¶ 74 and 75 (alleging that Stac in effect borrowed sales from future quarters, in violation of both Financial Accounting Standards Bulletin 48 and GAAP).

Only ¶¶ 55 materially differs – it alleges that the Prospectus was issued to raise capital that Stac would not be able to raise once the difficulties supposedly known only to Stac insiders came to light.

special terms – terms beyond those normally offered, including special price discounts and expanded rights of return. Stac then supposedly understated its required reserves. The net effect was to "borrow" sales from future periods, ensuring good numbers prior to the IPO, and bad ones afterward. SAC at ¶ 6.

4. That for all the above reasons, Stac's business had peaked and was entering a period of protracted decline – and Defendants knew it. SAC at ¶ 49(j).[8]

B. Plaintiffs' Legal Theory

Plaintiffs' theory is that Defendants committed a "fraud on the market." A Ninth Circuit case explains the fraud on the market theory in the following way:

> In a fraud on the market case, the plaintiff claims that he was induced to trade stock not by any particular representations made by corporate insiders, *but by the artificial stock price set by the market in light of statements made by the insiders as well as all other material public information.*

In re Apple Computer Securities Litigation, 886 F.2d 1109, 1114 (9th Cir. 1989), *cert. denied*, 496 U.S. 943 (1990) (emphasis added).

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[8] Despite repetition, these are the sum and substance of the allegations. *See, e.g.*, SAC at ¶ 44(a)-(f) (detailing ways road shows were misleading), ¶ 49(a)-(m) (detailing ways statements in Prospectus were misleading), ¶ 64 (a)-(e) (detailing ways analyst's report was misleading).

To prevail in a fraud on the market case, "the plaintiffs must demonstrate that a particular statement, *when read in light of all the information then available to the market*, or a failure to disclose particular information, conveyed a false or misleading impression." *In re Convergent Technologies Securities Litigation*, 948 F.2d 507, 512 (9th Cir. 1991) (emphasis added).

The test for misleadingness is "whether a reasonable investor would have been misled about the nature of his investment in [the] stock." *Verifone*, 11 F.3d at 869 (citing *Durning v. First Boston Corp.*, 815 F.2d 1265, 1268 (9th Cir. 1987), *cert. denied*, 484 U.S. 944 (1987)).

Fraud on the market theory pertains to both Section 11 and to Section 10b claims. As one of the most recent Ninth Circuit cases explains, both Section 11 of the Securities Act and Section 10b of the Exchange Act require a plaintiff adequately to allege that the defendants were responsible for a misrepresentation, or a material omission: Section 11 is limited to statements made in a prospectus; Section 10b includes prospectuses, documents, or oral communications. *Id.* at 868-69 (citing *In re Lyondell Petrochemical Co. Sec. Litig.*, 984 F.2d 1050, 1052 (9th Cir. 1993)).

C. Section 11 of the Securities Act

Section 11 of the Securities Act creates a private remedy for any purchaser of a security if any part of the registration statement,

> when such part became effective, contained an untrue statement of a material fact or omitted to

> state a material fact required to be stated therein or necessary to make the statements therein not misleading. . . .

15 U.S.C. § 77k(a).

A Section 11 claim can be asserted against every person who signed the prospectus, the issuer's officers and board of directors, the underwriters of the securities offering, and any expert whose profession gives authority to that part of the registration statement he or she prepared. *Id.*[9]

By its terms Section 11 concerns only registration statements. In the instant action, therefore, the roadshow presentations, analysts' reports, and statements to investment publications cannot support a Section 11 claim.

Section 11 addresses both positive misrepresentations and omissions. A Section 11 claim can assert that the Prospectus was defective either: (1) because it contained *untrue* statements of material fact; or (2)(a) because it omitted *required* statements of material fact, or (b) because it omitted statements of material fact *necessary to make statements contained in the Prospectus not misleading.*

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[9] The venture capital Defendants – Sigma Partners, Sigma Management, and Sigma Management II, L.P., as well as Crosspoint Venture Partners and Idanta Partners – move to dismiss Claim I of the SAC on the ground that they are not among the statutorily defined classes of defendants under Section 11.

They are correct, as Plaintiffs reluctantly and tardily concede. *See* Plaintiff's Memorandum to Motions of Defendants Finch et al., footnote 6.

1. Untruths or Omissions?

Here the Complaint repeatedly alleges that much of the Prospectus was *both* false and misleading. On examination, however, it is apparent that the SAC does not allege so much that the factual statements in the Prospectus are false as that Defendants omitted to disclose information necessary for investors to properly value Stac stock. *See In re Verifone Securities Litigation*, 784 F. Supp. 1471, 1480 (N.D. Cal. 1992).

Although difficult to sort out, the statements that are alleged to be misleading appear to be the following.

First, the Prospectus allegedly made misleading statements about the proprietary status of Stac's technology (¶ 46 and ¶ 10). Plaintiffs allege that Defendants failed to disclose that "the Company's LZS technology did not use proprietary algorithms and, in fact, key parts of such technology were in the public domain and could be utilized by others to quickly and cheaply create competitive products." SAC at ¶ 49.

Second, the Prospectus allegedly contained misleading financial statements (¶ 47 and ¶¶ 9-10). There are two subparts to these allegations.

For one, the SAC alleges that Stac's financial statements were misleading because they failed to disclose that "factors then existed that had caused [Stac's recent success] to end, would cause demand for Stac's products to weaken, and would result in Stac's revenues, net income and earnings per share declining sharply immediately after its offering." SAC at § 47; *see also* ¶¶ 9 and 47. Put another way, Plaintiffs allege that the Prospectus

was misleading in suggesting how Stac's past results should be interpreted to predict future performance (¶¶ 59 and 60).

For another, Plaintiffs allege that the Prospectus's explanations of Stac's success in the March 1992 quarter – increased demand and favorable awards and reviews – were misleading.(¶¶ 9, 10, 11, 48, 49, and 59),[10] as was its assertion that the company followed an established discount structure (¶ 48). Plaintiffs allege that Stac's recent favorable financial results instead stemmed from "special sales incentive terms, including price discounts and rights of return beyond those it normally granted," as well as consignment sales. Because of those special sales incentive terms, Plaintiffs allege, "Stac's revenues and net income were going to decline sharply." SAC at ¶ 49(e)-(i).

Third, the Prospectus allegedly made misleading statements concerning Stac's return and reserve policies (¶ 50). In particular, the Prospectus stated that "[a]lthough the Company believes that it provides adequate allowances for returns, there can be no assurance that actual returns in excess of recorded allowances will not result in a material adverse effect on the Company's business, operating results or financial condition." Prospectus at 7. The SAC alleges, however, that "Stac knew that its existing reserve for returns was inadequate and that this would require Stac to take increased reserves as charges to earnings in the future as those special rights of

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[10] The Court notes that the Prospectus states that the increased demand for Stacker was "the result of increased marketing and selling efforts." *See* SAC at ¶ 48.

return were exercised as Stac knew they would be. . . . " SAC at ¶ 51(b).

Fourth, Plaintiffs allege that the Prospectus contained misleading statements concerning the competition Stac faced (¶ 52). While the Prospectus portrayed Stac as well-positioned to meet competition, Plaintiffs allege that the Defendants concealed the true facts, which were: that demand for Stacker was weakening because of a new and successful competitive product, and that Microsoft had decided to include data compression in its next version of MS-DOS, which would further undermine Stac's position.[11]

Fifth, Plaintiffs allege that the Prospectus contained misleading statements concerning Stac's relationship to Microsoft (¶ 58). Where the Prospectus stated that "There can be no assurance that Microsoft . . . will not incorporate a competitive data compression technology in [its] products," Prospectus at 5, Plaintiffs allege that Stac had

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[11] Plaintiffs also allege that the Prospectus contained false and misleading statements concerning the purpose of the IPO (¶ 54). While the Prospectus stated that the principal purpose of the IPO was to increase Stac's capital and its sales, Plaintiffs allege that the IPO's true purposes were to allow insiders to sell their stock and for Stac to raise cash as a buffer against adversity, before the true facts about Stac became known.

These statements were not misleading. Because the allegation in ¶ 54 relies on other allegations concerning omissions, and because this Court finds that the Prospectus actually disclosed the purported omissions, or that Stac was not required to make the disclosures, it follows that the allegation in ¶ 54 also fails to state a claim.

learned that Microsoft had decided to include data compression in its next version of MS-DOS, and that Stac tried to delay Microsoft's announcement of its decision until after the IPO.

The Court takes these allegations in turn.

2. Proprietary Algorithms

The SAC alleges that statements in the Prospectus were misleading because Stac failed to disclose that Stac's products were neither proprietary nor adequately protected by patent.

But the statements in the Prospectus were not misleading. The Prospectus disclosed that Stac's competitive position depended on such protections, which the Prospectus explicitly cautioned were uncertain. *See* Prospectus at 6-7 (section entitled "Patents and Proprietary Information" ["There can be no assurance . . . that the Company's patents or copyrights will provide adequate protection"]) and at 25 (section entitled "Patents, Trademarks and Product Protection" ["The status of patents covering data compression technology is highly uncertain"]).

In addition, the recent verdict in *Stac Electronics v. Microsoft Corp.*, Civil No. 93-0413-ER (Bx) (C.D. Cal. 1994), undercuts the allegations in the SAC. The validity of a Stac patent was upheld, and Stac was awarded $120 million for infringement by Microsoft. This Court may take judicial notice of this verdict. *See Mack v. South Bay Beer Distributors, Inc.*, 798 F.2d 1279, 1282 (9th Cir. 1986). The verdict shows that what the Prospectus said was not

misleading: although the protection its patents provided was uncertain, Stac did indeed possess patents protecting its data compression technology.

For these reasons, this Court finds that the purported omission was actually disclosed, and in a way that made the statements in the Prospectus not misleading.

3. Predicting the Future

Plaintiffs repeatedly quote the following: "To warn that the untoward *may* occur when the event is contingent is prudent; to caution that it is *only possible* for the unfavorable events to happen when they have *already occurred is deceit." Huddleston v. Herman & MacLean,* 640 F.2d 534, 544 (5th Cir. 1981), *aff'd in relevant part and rev'd in part on other grounds,* 459 U.S. 375 (1983); *see* Plaintiffs' Memorandum to Motion of Defendants Stac et al. at 2 and 15. Plaintiffs rely on this quotation in the following way: they allege that the Prospectus made misleading statements because it failed to disclose that "factors then existed that had caused [Stac's recent success] to end, would cause demand for Stac's products to weaken, and would result in Stac's revenues, net income and earnings per share declining sharply immediately after its offering." SAC at ¶ 47; *see also* ¶¶ 9 and 47.

Similarly, Plaintiffs allege that the Prospectus contained misleading statements about how Stac's past results should be interpreted to predict future performance (¶¶ 59 and 60). The statements alleged to be misleading include the following: the statement that "there can be no assurance that the Company will sustain

its recent rate of revenue growth or maintain profitability;" and the statement that "[t]he Company has historically experienced significant fluctuations in its operating results, including net income, and anticipates that these fluctuations will continue. . . . As a result, the Company believes that period-to-period comparisons of its operating results should not be relied upon as an indication of future performance." Prospectus at 5, 7.

This Court finds that the statements in the Prospectus were not misleading. Two reasons support the finding. First, Plaintiffs' argument is belied by their own complaint. The SAC repeatedly speaks in terms of concurrent and future events, not in terms of the past. Notably, the SAC does not allege that unfavorable events had *already* occurred. Rather, the SAC repeatedly uses such formulations as: Stac "*was entering* a period of adversity" (SAC at ¶ 7); Stac's "future financial results *would decline* after March 31, 1992" (SAC at ¶ 6); "Stac sales *were already softening*" (SAC at ¶ 6); and Stac "*would not be able to continue to achieve* the kind of revenue and income gains in the future that it had enjoyed in the recent past" (SAC at ¶ 4).

This is the language of futurity and concurrence, not the language of past events. Hence Plaintiffs, chosen quotation hurts rather than helps their argument: their allegations do not amount to allegations that unfavorable events had already occurred, but rather to allegations that unfavorable events would occur.

Second and more important, one of the most recent Ninth Circuit cases concerning securities affirmed dismissal of a complaint making strikingly similar allegations. In *Verifone*, the complaint alleged that the following facts were undisclosed: that sales growth *had slowed substantially*, that unit sales *had materially declined*, that the company's sales channels *were showing little growth. Verifone*, 11 F.3d at 869, 872. The allegations in Plaintiff's SAC are if anything *weaker* than the allegations in *Verifone*: in *Verifone*, at least, the allegations were that sales growth, for example, *had already slowed*; here the allegations are that Stac *was entering* a period of decline.

For these reasons, the Court finds that the Prospectus's statements concerning Stac's financial record – and in particular, its statements about how to interpret past results for predicting future performance – were not misleading.

4. Borrowing from Future Sales: Special Deals and Inadequate Reserves

The FAC alleged that Stac had stuffed its distribution channel, and that that fact was not disclosed.

Examination of the Prospectus showed, however, that Stac did disclose that its quarterly reports needed to be considered in light of "channel fi11.[12] Stac also made the

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[12] As Defendants pointed out, they were not required to use the expression chosen by the Plaintiffs. Defendants were "under no duty to 'characterize the basic underlying facts with pejorative descriptions. . . . ' " *Sun Microsystems*, at 97,637 (citation omitted) (quoting *McMahan & Co. v. Wherehouse*

disclosure in a way that made the Prospectus's statements not misleading.[13]

Entertainment Co., [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,510 at 93,243.(S.D.N.Y. 1989)).

[13] This Court's Order of September 17, 1993 relied upon the following disclosures: Under the heading "Quarterly Trends," in the section entitled "Management's Discussion and Analysis of Financial Condition and Results of Operations," the Prospectus cautioned that Stac's quarterly results were subject to variation, in part because of channel fill. The Prospectus noted that "[t]he Company's results of operations are subject to significant quarterly variations as a result of a number of factors and risks, including the phenomenon of 'channel fill' during initial shipments of new versions or new products. . . . " Prospectus at 16. Channel fill, the Prospectus explained,

> often occurs following the introduction of a new product or a new version of a product as distributors buy significant quantities of the new product or version in anticipation of sales of such product or version. Following such purchases, the rate of distributor's purchases may decline.

Prospectus at 16. The Prospectus also explicitly stated that Stac had just recently released Version 2.0 of its Stacker product. *Id.* Hence, readers of the Prospectus were alerted to the likelihood that distributors would make fewer purchases of Stacker in the immediate future.

In addition, reading the Prospectus showed that it contained statements explaining Stac's return policy. It also cautioned that Stac's allowance for returns might not be adequate. Both these disclosures made the Prospectus's statements – in particular, of results for the quarter ended March 31, 1992 – not misleading.

In the "Risk Factors" section, under the heading "Reliance on Distributors," the Prospectus stated that "[m]ost of the Company's revenues from the Stacker products are realized through distributors that are not under the direct control of the Company." Prospectus at 7. It went on to warn that distributors

The SAC alleges, however, that Defendants engaged in a complicated scheme to commit a fraud on the market:

> could reduce their support of the Company's products or discontinue carrying the Company's product line, which could have a material adverse effect on the Company's business, operating results and financial condition. Like other manufacturers of packaged software products, the Company is exposed to the risk of product returns from distributors and direct reseller customers.

Id.

At the end of the paragraph, the Prospectus referred the reader to two additional sections – "Management's Discussion and Analysis of Financial Condition and Results of Operations" and "Business – Marketing and Sales." The latter explained Stac's return policy.

> The Company's return policy allows its distributors to return any new, unused product in the distributor's inventory within a contractually defined period of 60 days from the notice of discontinuance of any product, or any version of a product, for a credit or cash refund. In addition distributors may participate quarterly in a stock balancing program which, subject to certain limitations, allows them to return purchased products within the second month of each calendar quarter for full credit towards future purchases.

Prospectus at 22.

An additional risk connected with Stac's return policy involved the possibility that the Company might not make adequate allowance for returns. The Prospectus stated that

> [a]lthough the Company believes that it provides adequate allowances for returns, there can be no assurance that actual returns in excess of recorded allowances will not result in a material adverse effect on business. . . .

according to Plaintiffs, Stac artificially inflated its financial success for the period immediately before the IPO, by offering its customers special terms – terms beyond those normally offered, including special price discounts and expanded rights of return. Stac then understated its required reserves. The net effect, Plaintiffs allege, was to "borrow" sales from future periods, ensuring good numbers prior to the IPO, and bad numbers afterwards.

According to the SAC, these undisclosed facts rendered misleading the Prospectus's financial statements (SAC at ¶ 47). In addition, these undisclosed facts rendered misleading the Prospectus's statements concerning the regularity of Stac's marketing and selling efforts and established discount structure (SAC at ¶ 48).[14] They also rendered misleading its statements concerning return policy and adequacy of reserves (SAC at ¶ 50).

This Court finds that the SAC fails to state a claim, for the following two reasons: first, the SAC's allegations

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Prospectus at 7. The Prospectus did state that "[t]o date, product returns have not had a material effect on the Company's results of operations in any period." *Id.* But as the previously quoted language indicates, that did not mean that Stac assured its investors that product returns could not exceed allowances in the future.

In sum, the Prospectus explained Stac's return policy and cautioned that actual returns might exceed allowances. Hence this Court found and finds now that the disclosures made the statements concerning revenues and sales for the quarter ended March 31, 1992 not misleading.

[14] The Prospectus stated, for example, that "The Company does not believe that its discounting activities have significantly affected revenues or results of operations in any given period."

are essentially the same as the FAC's allegations; and second, in any case the instant action is distinguishable from a recent Ninth Circuit case which alleged misleading statements concerning the adequacy of reserves – *In re Wells Fargo Securities Litigation*, 12 F.3d 922 (9th Cir. 1993).

First, this Court has previously discussed – and dismissed – Plaintiffs' allegations of channel stuffing. It found that the Prospectus adequately alerted investors to the likelihood that distributors would make fewer purchases of Stacker in the immediate future. It also noted that there were no allegations that Stac unilaterally overshipped product to distributors.

Second, this case is distinguishable from *Wells Fargo Securities*, a recent Ninth Circuit case in which there were allegations of misleading statements concerning the adequacy of reserves. In that case, the district court had dismissed the complaint, which was brought under Rule 10b-5 and other statutes.[15] The complaint had alleged that senior officers and directors had fraudulently withheld material information about the security of certain of its loans. The theory was virtually identical to the theory

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[15] Since under either Section 11 or Rule 10b-5 a plaintiff must adequately allege a misrepresentation or material omission, *Verifone*, 11 F.3d at 868-69 (citing *In re Lyondell Petrochemical Co. Sec. Litig.*, 984 F.2d 1050, 1052 (9th Cir. 1993), and since the above discussion concerns whether the SAC adequately alleges a misrepresentation or material omission, *Wells Fargo* is pertinent to the instant case.

here: the complaint alleged that the defendants had deliberately understated Wells Fargo's loan loss reserves, thus artificially inflating the trading price of Wells Fargo stock.

The Ninth Circuit reversed, finding that plaintiffs had stated a claim. The shareholders had alleged that "Wells Fargo knew of certain 'contingencies' which rendered its loan reserves inadequate, and failed to disclose this information to purchasers of its stock." *Id.* at 927.

But there was more to the complaint, which enabled it to survive a motion to dismiss. The *Wells Fargo* court noted that the complaint identified "specific, substantial loans" – indeed, it identified nine loans by name. It also alleged the dollar amount of the understatement – some $400 million. Hence, the complaint contained the "something more" the court required for it to survive a motion to dismiss: the complaint identified "certain, specific loans extended to identified borrowers." *Id.* at 926-27.

Here, by contrast, the SAC states only that Stac offered its customers special terms – terms beyond those normally offered, including special price discounts and expanded rights of return. It also alleges that Stac understated its required reserves, having the net effect of "borrowing" sales from future periods, and ensuring good numbers prior to the IPO, and bad numbers afterwards.

Unlike the complaint in *Wells Fargo*, however, the SAC does not identify customers, for example, nor does it state how far off the reserves were. In addition, the SAC fails to state how the special price discounts and expanded rights of return *differed* from the policies actually disclosed in the Prospectus.

There was a second reason why the complaint in *Wells Fargo* survived the motion to dismiss. There Wells Fargo had made two statements: "The Company believes at the present time that these loans are substantially secured by the assets of the borrowers" and "The Company considers the allowance for loan losses of $885.4 million adequate to cover losses inherent in loans." *Id.* at 930. The court noted that "Where a defendant affirmatively characterizes management practices as 'adequate' or loans as 'substantially secured,' " three factual assertions are implied: "(1) that the statement is genuinely believed, (2) that there is a reasonable basis for that belief, and (3) that the speaker is not aware of any undisclosed facts tending to seriously undermine the accuracy of the statement." *Id.*

Here the SAC does not similarly allege that the Prospectus contained affirmative statements. Indeed, the Prospectus states that no assurance could be given that Stac's allowance for returns was adequate. Prospectus at 7, 22 (stating that "although the Company believes that it provides adequate allowances for returns, there can be no assurance that actual returns in excess of recorded allowances will not result in a material adverse effect on business"). Hence Stac not only did not make assurances, but it explicitly disclaimed that assurances could be given. It also warned investors that future results could be less favorable, if allowances were less than adequate.

5. Competitive Products and Microsoft Looming

Plaintiffs allege that Stac failed to disclose the effect of competition on demand for Stacker products, making statements concerning Stac's competitive position misleading. *See* SAC at 52. The SAC also alleges that statements concerning Stac's position vis a vis Microsoft were especially misleading. *See* SAC at 58.

In particular, Plaintiffs allege that various statements in the Prospectus were misleading because there was failure to disclose: that a new competitive product was affecting demand for Stacker; that competition from Microsoft was imminent; that Stac was negotiating with Microsoft over licensing the former's technology; that – even worse – Stac's purpose in the licensing negotiations was to stall Microsoft's entry until after the IPO; and that for these reasons, Stac's business had peaked and was entering a period of protracted decline.

This Court previously found that the Prospectus disclosed the effect of competition, and that it did so in a way that was not misleading. That finding still stands.

As this Court previously noted, the Prospectus makes detailed disclosures concerning the risks of competition. Under the heading "Competition," the Prospectus noted that the market for Stac's products was intensely competitive. "A number of competitors offer products that currently compete with . . . the Company's products," the Prospectus stated; and competitors might successfully offer products "that could render obsolete or adversely affect sales of the Company's products." Prospectus at 5.

The Prospectus observed that a number of Stac's competitors had more resources than Stac. Further, while most of Stac's revenues derived from sales of products that operated under Microsoft's MS-DOS system (i.e., from sales of Stacker), "there can be no assurance that Microsoft . . . will not incorporate a competitive data compression technology in their products or that such a technology will not otherwise emerge as an industry standard." Prospectus at 5.

The Prospectus also noted that Stac licensed and intended to license portions of its core technology to other companies. In turn, those other companies might increase the competition Stac faced. The upshot, the Prospectus continued, was that "[i]ncreased competition could result not only in a decline in sales volume but also in price reductions that could have a material adverse effect on the Company's business. . . . " Prospectus at 5. For these reasons, this Court's September 17, 1993 Order found that the Prospectus disclosed the effect of competition on Stac.

The SAC makes further allegations, especially concerning Microsoft. It alleges that Stac and its officers *knew* that Microsoft intended to offer data compression with its new software, and that Stac and its officers engaged in sham licensing negotiations with Microsoft, in an effort to delay Microsoft's entrance into the data compression market until after Stac's IPO.

But as the above quoted passages made clear, the Prospectus disclosed both that Microsoft might incorporate data compression into its software, and that Stac

might license its technology to competitors – which would necessarily include Microsoft.

In addition, Plaintiff's own complaint belies the assertion that information concerning Microsoft's entry was unavailable to the market. The SAC itself states that the market *already knew* that Stac was vulnerable to Microsoft, and indeed *anticipated* Microsoft's entry into the data compression field. *See* SAC at ¶ 4 (stating that demand for Stacker had weakened "due to customer resistance to purchasing separate data compression software products *in anticipation* of the availability of upgraded personal computer operating systems that included data compression capacity").[16] "[I]n a fraud on the market case, the defendant's failure to disclose material information may be excused where that information has been made credibly available to the market by other sources." *Apple Computer Securities*, 886 F.2d at 1115. Because the SAC itself asserts that the market already anticipated Microsoft's entry, it was not required that the Prospectus announce that Microsoft had decided to enter the field, and any delay from alleged sham negotiations would be immaterial.

For the above reasons, this Court finds that the SAC does not adequately allege a material misrepresentation or omission concerning a new competitive product or imminent competition from Microsoft.

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[16] *See also* FAC ¶ 43(e). Plaintiffs' allegations in their prior pleading are admissible against them as admissions. *Haynes v. Manning*, 717 F. Supp. 730, 733 (D. Kan. 1989) *aff'd in part and rev'd in part*, 917 F.2d 450 (10th Cir. 1990).

6. Summary of Section 11 Claims

This Court has found that the Prospectus either actually discloses the purported omissions, in ways that make the Prospectus's statements not misleading, or that Defendants were not required to disclose purported omissions. Hence the allegations concerning the proprietary status of Stac's products, competition, and Microsoft's relationship to Stac are dismissed. In addition, the allegations concerning the financial statements – that Stac failed to disclose that it embarked on a plan involving heavy discounts, enhanced rights of return, and consignment sales, combined with understated and inadequate reserves, all of which together led to misleading financial statements – are also dismissed, because they too fail adequately to plead a material misrepresentation or omission. Hence this Court finds that Count I of the Complaint fails to state a claim upon which relief can be granted, as against both Stac and the individual named Defendants *and* the underwriter Defendants.

7. Prospectus as a Whole

The above sections show that the Prospectus disclosed the particular material facts, purportedly omitted, which were necessary to make statements in the Prospectus not misleading. This Court finds that the Prospectus also included other statements which rendered the Prospectus *as a whole* not misleading.

First, Stac prominently characterized its stock as having a "high degree of risk." Prospectus at 3. Second, Stac did not simply rely on a general statement about risk: the

Prospectus also contained a lengthy and detailed section entitled "Risk Factors." Prospectus at 5-8. Indeed, that section was the *first* to appear in the body of the Prospectus, after a section describing the company. Third, as discussed immediately above, each of the allegedly omitted facts was disclosed in the Prospectus, either in the Risk Factors section or in other sections to which the discussion in the Risk Factors section explicitly referred the reader, or Stac was not required to make the disclosures.

In addition, the Prospectus repeatedly cautioned that Stac's quarterly results fluctuated, so that "period-to-period comparisons of its operating results should not be relied upon as an indication of future performance." Prospectus at 6. Insofar as Plaintiffs suggest that the Prospectus was misleading if taken as indicative of Stac's future performance, the statements concerning quarterly fluctuations adequately warned investors against relying on such comparisons.

Similarly, the Prospectus disclosed the dependence of Stac on Stacker products, and noted that rapidly changing technology "could render existing products obsolete and unsalable." Prospectus.at 5, 6. Because of these and other factors, the Prospectus continued, the "[m]arket price of the shares of Common Stock . . . is likely to be highly volatile." Prospectus at 8.

B. Violation of Section 15 of the Securities Act

Plaintiffs charge that the individual named Defendants and the venture capital Defendants are also liable

under Section 15 of the Securities Act. Section 15 of the Securities Act states that

> Every person who, by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls any person liable under sections 77k or 771 of this title, shall also be liable jointly and severally with and to the same extent as such controlled person. . . .

15 U.S.C 78t. Hence Section 15 extends liability to so-called controlling persons:[17] persons who control those found liable under Section 11 are also liable to plaintiffs.

Liability under Section 15 is thus predicated on finding a violation of Section 11. Here Plaintiffs do not state a claim under Section 11, for the reasons given above. Therefore the motion to dismiss Count II of the Complaint is granted.

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[17] In *Wanetick v. Mel's of Modesto. Inc.*, 811 F. Supp. 1402, 1407 (N.D. Cal. 1992), the court defined "control" as follows: "a person controls an individual or entity if he or she possesses, directly or indirectly, 'the power to direct or cause the direction of management and policies of a person, whether through ownership of voting securities, by contract or otherwise.' " *Id.* at 1407 (citing 17 C.F.R. § 230.405).

C. Violation of Section 10(b) of the Exchange Act and Rule 10b-5 of the Securities and Exchange Commission

1. Legal Standard: Statute and Rule

Section 10(b) of the Exchange Act provides that "it shall be unlawful for any person . . . to use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe." 15 U.S.C. ¶ 78j(b).

Securities and Exchange Commission Rule 10b-5, promulgated under authority of Section 10(b), further provides:

> It shall be unlawful for any person. . . .
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statement made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

17 C.F.R. ¶ 240.10(b)(5).

The Supreme Court has also held that for a defendant to be liable under Rule 10b-5, there must be a showing of scienter, defined as a "mental state embracing intent to deceive, manipulate, or defraud." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 194 and n.12 (1976). The Ninth Circuit, however, has held that scienter can be proved by a showing of recklessness on the part of the defendant. *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1568-69 (9th Cir. 1990), *cert. denied*, 111 S. Ct. 1621 (1991).[18]

2. Legal Standard: Pleading Fraud With Particularity

Because Rule 10b-5 claims sound in fraud, they must meet the particularity requirements of Fed. R. Civ. P. 9(b). *Wool v. Tandem Computers, Inc.*, 818 F.2d 1433, 1439 (9th Cir. 1987); *see generally*, Hazen, *Securities Regulation*, Vol. 2, at 66.

Fed. R. Civ. P. 9(b) states that "[i]n all averments of fraud and mistake, the circumstances constituting fraud or mistake shall be stated with particularity. Malice,

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[18] For the purposes of Rule 10b-5, reckless conduct is defined as conduct

> involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers and sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.

Id. at 1569 (quoting *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1045 (7th Cir. 1977), *cert. denied*, 434 U.S. 875 (1977)).

intent, knowledge, and other condition of mind of a person may be averred generally."

The Ninth Circuit has interpreted Rule 9(b) to mean that "the pleader must state the time, place, and specific content of the false representations as well as the identities of the parties to the misrepresentation." *Schreiber Distributing v. Serv-Well Furniture Co.*, 806 F.2d 1393, 1401 (9th Cir. 1986) (citing *Semegen*, 780 F.2d at 731).

Rule 9(b) is meant not only to enable defendants to respond to the complaint, but also to accomplish three other goals: first, to prevent complaints from being used as a "pretext for the discovery of unknown wrongs;" second, to protect "potential defendants – especially professionals whose reputations in their fields of expertise are most sensitive to slander – from the harm that comes from being charged with the commission of fraudulent acts;" and third, "to prohibit a plaintiff from unilaterally imposing upon the court, the parties and society enormous social and economic costs absent some factual basis." *Semegen*, 780 F.2d at 731.

4. The Allegations

Here Plaintiffs make the same allegations concerning the Prospectus as for the Section 11 violation. In addition, they make allegations concerning roadshow presentations, analysts' reports, and statements to investment publications.

The Court takes these statements in turn, after addressing a threshold issue.

5. Statute of Limitations

The newly-named Defendants move to dismiss the entire SAC, on the ground that the statute of limitations bars the complaint against them.

The first complaints in this case were filed July 23 and 24, 1992 (Civ. No. 92-1120-R and Civ. No. 90-1125-R). Plaintiffs charged a group of Defendants with violations of Sections 11 and 15 of the Securities Act and violations of Sections 10(b) and 20(a) of the Exchange Act. After the Consolidated Amended Class Action Complaint was filed, it was dismissed by this Court's Order of September 17, 1993. Discovery was also stayed. Hence, one year and two months lapsed between the filing of the original complaints and the stay of discovery.

On November 18, 1993, Plaintiffs filed the SAC, adding the newly-named Defendants – roughly one year and four months after the original complaints were filed.

The statute of limitations governing Sections 11 and 10(b) requires filing a complaint within three years of offer or sale of a security, or within one year of actual notice or inquiry notice of an untrue or misleading statement.[19]

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[19] 15 U.S.C. § 77m states, in pertinent part, "No action shall be maintained to enforce any liability . . . unless brought within one year after the discovery of the untrue statement or the omission, or after such discovery should have been made by the exercise of reasonable diligence." That section expressly governs Section 11; the United States Supreme Court has held that 15 U.S.C. ¶ 77m also governs Section 10(b). *Lampf, Pleva, Lipkind, Prupis and Petigrow v. Gilbertson*, 501 U.S. 350, 111 S. Ct. 2773, 2781 (1991).

Defendants argue that the complaints against the newly-named Defendants are time-barred. This Court agrees. It also notes that, despite their protestations, Plaintiffs are hoist by their own petard. The fact that they filed the July 23 and 24, 1992 complaints – as well as the fact that each of the newly-named Defendants was identified in the very Prospectus at issue in those complaints – establishes that they were on inquiry notice of securities violations.

Plaintiffs argue that the statute of limitations requires that they be on notice as to the participation of each Defendant in the fraud. In addition, Plaintiffs contend that at the time they filed their original complaints, they did not have sufficient information to suspect the involvement of the newly-named Defendants. Finally, Plaintiffs argue that they obtained sufficient information concerning the involvement of the newly-named Defendants only after Plaintiffs obtained discovery from the litigation between Stac and Microsoft, in February of 1993.

Plaintiffs' argument is wholly unpersuasive. The question of when a plaintiff discovered or should have discovered wrongdoing is ordinarily a question for the trier of fact, *Briskin v. Ernst & Ernst*, 589 F.2d 1363, 1367-69 (9th Cir. 1978); *Mosesian v. Peat Marwick, Mitchell & Co.*, 727 F.2d 873, 877 (9th Cir.), *cert. denied*, 469 U.S. 932 (1984). But it is also true – as Plaintiffs themselves concede – that the question can be decided as a matter of law, when uncontroverted evidence irrefutably demonstrates that a plaintiff discovered or should have discovered the fraud. *Wade v. Industrial Funding Corp.*, 1993 WL 650837 (N.D. Cal. 1993) (citing *Mosesian*, 727 F.2d at 877).

Here one fact shows irrefutably that Plaintiffs discovered fraud – they filed lawsuits making fraud allegations. Another fact shows irrefutably that, from the dates of the original complaints, Plaintiffs were on inquiry notice, even as to the newly-named Defendants, i.e., that, from the dates of the original complaints, they should have discovered fraud, even as to the newly-named Defendants. That fact is that the very Prospectus at issue in the complaints specifically identified the newly-named Defendants as officers, directors, and substantial investors[20] in the issuing company. These two facts – that Plaintiffs filed lawsuits alleging fraud and that the very Prospectus at issue in those complaints prominently identified those Defendants newly named in the SAC – together demonstrate irrefutably that Plaintiffs were on inquiry notice of claims against the newly-named Defendants.

In further support of this ruling, the Court notes that the SAC itself renders completely implausible the argument that Plaintiffs did not have enough information to suspect fraud on the part of the newly-named Defendants. It is not as if the SAC relies on factual allegations, or allegations concerning particular events, to assert causes of action against the newly-named Defendants; it is not as if the SAC alleges that Witzel, for instance, personally engaged in sham negotiations with Microsoft. Rather, it relies merely on the *corporate positions* of the

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[20] Indeed, Plaintiffs now allege the venture capital Defendants were controlling persons of Stac, in virtue of their ownership of Stac stock – which ownership was as apparent when Plaintiffs filed their original complaints as it is today.

newly-named individual Defendants (*see* SAC 23(k)), and merely on the *ownership of Stac stock* by the newly-named venture capital Defendants (*see* SAC 23(j)). Because those facts appear on the face of the Prospectus, those facts were equally available to Plaintiffs from the date of the first complaints. It required no discovery to make these allegations in the SAC. It would have required no discovery to make the very same allegations on the date of the first complaints.

For the above reasons, both the Section 11 and the Section 10b-5 claims (Claims I and III) are dismissed as against the newly-named Defendants – Defendants Witzel, Hoff, Crosspoint Venture Partners, Finch, Sigma Management, Sigma Management II, L.P., Sigma Partners, Robelen, and Idanta Partners – with prejudice. Because the one year statute of limitations applies to secondary liability[21] and to control person liability[22] as well, those causes of action (Claims II and IV) are also dismissed as against the newly-named Defendants, again with prejudice.

6. Analysis of Particular Statements

a. Particular Statements: The Prospectus

This Order has already discussed the purported omissions from the Prospectus. It has found that the purported omissions were either actually disclosed, or

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[21] *Schwartz v. Michaels*, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,920 at 93,830 (S.D.N.Y. 1992).

[22] *Jolly v. Pittore*, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,943 at 94,008 (S.D.N.Y. 1992).

that they were not necessary to be disclosed to make statements in the Prospectus not misleading.

There is also an allegation of false financial statements. SAC at ¶ 74. Plaintiffs allege that Stac's financial statements were generated in violation of Generally Accepted Accounting Principles and Financial Accounting Standards Bulletin 48, which states that "Sales revenue and cost of sales reported in the income statement shall be reduced to reflect estimated returns." *Id.* That allegation is insufficient, however, because it is a mere summary of the allegation concerning Stac's allegedly insufficient allowance for returns – which allegation was previously found deficient.

Stac and Clow, Whiting, Johnson, and Collmeyer move to dismiss the Rule 10b-5 claims arising from the Prospectus on the additional ground that Plaintiffs fail to plead any facts giving rise to an inference of scienter.

The underwriter Defendants move to dismiss the Rule 10b-5 claims stemming from the Prospectus on two additional grounds: first, they argue – along with Stac and the individual named Defendants – that the Complaint fails to allege facts supporting an inference of scienter; and second, they contend that the SAC fails to identify the role of the underwriters in the alleged fraud with sufficient particularity.

Similarly, the newly-named Defendants move to dismiss on the ground that the SAC fails to plead facts giving rise to an inference of scienter and that the SAC fails to identify the role of the outside director and venture capital Defendants in the alleged fraud with sufficient particularity. In particular, they argue that

statements by Stac cannot be attributed to the outside director and venture capital Defendants through group pleading.

This Court finds that, with respect to the allegedly fraudulent statements contained in the Prospectus, the Complaint fails to state Rule 10b-5 claims against Stac and the individual named Defendants *and* the underwriter Defendants *and* the venture capital Defendants.

i. Scienter

First, the Complaint is deficient because it fails to allege facts supporting an inference of scienter. The Ninth Circuit has recently ruled that "[a]lthough Rule 9(b) allows scienter to be pleaded generally, courts have required that the facts pled provide a strong inference of fraudulent intent." *GlenFed*, 11 F.3d at 848; *see also Verifone*, 11 F.3d at 868; *Neubronner*, 6 F.3d at 672. The necessary scienter may be satisfied by actual knowledge or by a heightened standard of recklessness involving an extreme departure from ordinary care. *GlenFed*, 11 F.3d at 847 (citing *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1569-70 (9th Cir. 1990) (en banc), *cert. denied*, 111 S. Ct. 1621 (1991)).

Here Plaintiffs have failed to allege facts which provide a strong inference of fraudulent intent. Rather, the SAC relies on conclusory allegations of knowledge or recklessness. SAC at 88. Although Plaintiffs rely on *Wells Fargo* in support of their argument that the SAC sufficiently alleges scienter, *Wells Fargo* is distinguishable, as noted above: there Plaintiffs had alleged facts concerning certain specific loans extended to identified borrowers, and Defendants had affirmatively characterized their

allowance for loan losses as adequate. Hence, when considered with the motive of increased compensation, there were facts which provided a strong inference of fraudulent intent. Here Plaintiffs have not identified similar facts to provide a strong inference of fraudulent intent.

In addition, Plaintiffs allege that the individual named Defendants had a motive for fraud, since they stood to gain personally from sale of Stac stock. But it has been held that "insider trading, standing alone, may not give rise to an inference of scienter." *Smith v. Network Equip. Technologies, Inc.*, [1990-91 Transfer Binder] Fed. Sec. L. Rep (C.C.H. ¶ 95, 659 at 98,093 (N.D. Cal. 1990). Finally, the fact that all five of the Defendants who sold stock retained at least 85% of their stock throughout the class period cuts against an inference of scienter. *See In re Worlds of Wonder Sec. Litig.*, 814 F. Supp. 850, 869 (N.D. Cal. 1993).

The conclusion that the SAC does not plead facts which provide a strong inference of scienter applies even more forcefully to the underwriter Defendants. As these Defendants point out, mere descriptions of an underwriter's role, along with the fact that an underwriter receives fees, is not sufficient to raise a strong inference of fraudulent intent. *In re Software Toolworks, Inc. Securities Lit.*, 789 F. Supp. 1489, 1498-99 and n.16 (N.D. Cal.) (granting summary judgment on grounds that scienter was not proved where underwriters performed due diligence investigations and only motive was fees).

Finally, the conclusion that the SAC does not plead facts which provide a strong inference of scienter applies even more forcefully still to the outside director (Finch,

Hoff, and Robelen) and venture capital Defendants. None of these Defendants is alleged to have sold *any* Stac stock during the class period.

ii. Specific Roles

Second, the Complaint fails to identify the specific role of the Underwriters and the outside director and venture capital Defendants in propounding the allegedly fraudulent statements contained in the Prospectus. "[I]t is insufficient under Rule 9(b) to 'group [defendants] together without differentiating who might be primarily liable and who might be secondarily liable.' " *Lubin v. Sybedon Corp.*, 688 F. Supp. 1425, 1443 (S.D. Cal. 1988) (citation omitted). Instead, fraud allegations must inform each defendant of the conduct which constitutes the violation. *Id.* (citing *Hokama v. E.F. Hutton & Co., Inc.*, 566 F. Supp. 636, 645 (C.D. Cal. 1983)); *In re MDC Holdings Securities Litigation*, 754 F. Supp. 785, 795 (S.D. Cal. 1990).

iii. Group Pleading

Nor is the group pleading doctrine available. Under the group pleading doctrine, plaintiffs are exempted from the strictures of Rule 9(b) – in particular, they are exempted from specifying the particular role of defendants in the alleged fraud. The reason behind the group pleading rule is that in cases of corporate fraud the plaintiffs cannot be expected to have personal knowledge of the facts of the wrongdoing. *Wool*, 818 F.2d at 1440.

Here the underwriter, outside director, and venture capital Defendants all make essentially the same argument: since they are not alleged to have direct involvement in Stac's day-to-day affairs or its publications,

MDC, 754 F. Supp. at 795, and since they are not alleged to have a "special relationship" with the corporation, *Klein v. King*, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,002 at 95,609 (N.D. Cal. 1990), the group pleading doctrine does not apply. This Court agrees.

Because the group pleading doctrine is not available, and because the roles of the underwriter, outside director, and venture capital Defendants in propounding the allegedly fraudulent statements are left unspecified, it follows that Plaintiffs have not met the specificity requirements of Rule 9(b).

For these reasons, the allegations concerning the statements in the Prospectus are dismissed, for failure to comply with Fed. R. Civ. P. 9(b). The dismissal applies to both Stac and the individual named Defendants *and* the underwriter Defendants *and* the venture capital Defendants.

It remains to consider the so-called roadshow presentations, analysts' reports (including projections of earnings and revenues), and statements in investment publications. These allegations are also insufficient, for reasons essentially similar to those noted above.

b. Particular Statements: Roadshow Presentations

Plaintiffs allege that Defendants made false and misleading statements during roadshow presentations to promote the Stac offering. SAC at ¶¶ 42-44. Plaintiffs allege that Defendants stated that Stac's business was strong, and that its March 31, 1992 growth was strong as

well, due to favorable publicity and awards for Stacker; Plaintiffs also allege that Defendants forecasted strong revenue and net income growth, resulting in increased earnings per share. *Id.*

Like the allegations in the FAC, these allegations are inadequate under Fed. R. Civ. P. 9(b). Although Plaintiffs elsewhere speak generally of "defendants" and "Stac and its underwriters" as involved in the roadshow presentations, the allegations at SAC ¶¶ 42, 43, and 44 specifically identify only Defendants Clow and Witzel; and they state the time and place only in the broadest terms – three weeks before the IPO, in New York, Chicago, and San Francisco. While these allegations might be sufficient – barely – for notice, they are not particular enough to meet the other purposes of Rule 9(b) – to prevent complaints being used as a pretext for discovery of unknown wrongs, to protect professional reputations, and to prohibit plaintiffs from unilaterally imposing costs upon court, society, and parties absent some factual basis. *Semegen*, 780 F.2d at 731.

There is an additional reason dismissal is warranted. Although discovery is now stayed, Plaintiffs had 14 months in which to pursue discovery. Courts enforce the requirements of Rule 9(b) more strictly where discovery has progressed. *Neubronner*, 6 F.3d at 671-72; *GlenFed*, 11 F.3d at 848.

Finally, the arguments concerning scienter and concerning the failure of Plaintiffs to identify the specific roles of Defendants apply with equal force to the roadshow presentations. Just as Plaintiffs have not pled facts providing a strong inference of scienter concerning the

Prospectus, so too have they not pled facts providing a strong inference that Defendants – even the specifically named Clow and Witzel – either knew that their road-show presentations contained statements which were false, or that they were reckless in propounding them. Similarly, although Plaintiffs attempt to hold all Defendants liable for the allegedly misleading statements, nowhere do Plaintiffs specify the roles of each Defendant in the alleged fraud.

For these reasons, the allegations concerning road-show presentations are dismissed, as against all Defendants, for failure to state circumstances constituting fraud with particularity.

c. Particular Statements: Analysts' Reports and Projections

Plaintiffs allege that two analysts' reports – issued by the underwriter Defendants – also violated Rule 10b-5. SAC at ¶¶ 62-65. According to the SAC, the underwriter Defendants lacked a reasonable basis for and did not believe their projections of quarterly growth and earnings for Stac; Plaintiffs allege that essentially the same facts – allegedly undisclosed – which rendered the Prospectus misleading also rendered the analysts' reports misleading. SAC at ¶ 64. In particular, Plaintiffs emphasize the allegedly undisclosed fact that Microsoft was going to include data compression in its next MS-DOS upgrade.

Plaintiffs connect Stac and some of the individual named Defendants – "Stac insiders" – to these projections by averring that the reports were issued pursuant to an

agreement between Stac, Stac insiders, and the underwriter Defendants, where the reports would forecast growth in exchange for the underwriters being selected to handle the IPO. *Id.* Plaintiffs also allege that information contained in these reports was obtained from Stac or based on information obtained from Stac, and that copies of drafts of these reports were provided to Stac before they were released. *Id.*

i. Reports and Projections: Stac and the Individual Named Defendants and Venture Capital Defendants

Stac, the individual named Defendants, and the venture capital defendants all move to dismiss on the grounds: that the SAC does not plead facts showing their roles in propounding the allegedly fraudulent statements, and that the facts pled do not provide a strong inference of scienter, i.e., do not indicate that Defendants knew the projections lacked a reasonable basis when made, or were reckless concerning that possibility.

This Court agrees with Defendants. First, "[i]n order to be liable for unreasonably disclosed third-party forecasts, defendants must have put their imprimatur, express or implied, on the projections." *Verifone*, 784 F. Supp. at 1486. Here, as in *Verifone*, the Complaint has not stated facts with sufficient particularity to show how the corporate or venture capital Defendants "adopted" the analysts' reports. *Id.* at 1487.

Second, in any case the Complaint has also not stated facts with sufficient particularity to show why the corporate or venture capital Defendants had no reasonable basis to believe that the projections made could come

true, or that they knew the projections lacked a reasonable basis. *Id.* at 1486-87. For these reasons, the Rule 10b-5 claim, alleging fraudulent projections in the analysts' reports, is dismissed as against Stac and the individual named Defendants and the venture capital Defendants.

ii. Reports and Projections: Underwriter Defendants

The underwriter Defendants move to dismiss on the grounds that Plaintiffs again allege no facts showing scienter; and that the bare assertion that the projections lacked a reasonable basis when made or that the underwriter Defendants did not believe the projections is insufficient under Rule 9(b).

This Court agrees with the underwriter Defendants. In particular, the bare assertion that the projections lacked a reasonable basis when made or that the underwriter Defendants did not believe the projections is insufficient to satisfy either the scienter requirement of Rule 10(b) or the pleading requirements of Rule 9(b). *Id.* at 1490-91. Plaintiffs must assert facts which show that the underwriter defendants had no reasonable basis for or did not believe the projections made in the analysts' reports at the time that those reports were published. *Id.* at 1491.[23]

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[23] As noted in this Court's September 17, 1993 Order, and as the underwriter Defendants point out, to allow such pleadings to pass muster would be to allow claims every time projections differed at all from results. For, as Judge Easterbrook has noted, "[i]f all estimates are made carefully and honestly, half will turn out too favorable to the firm and the other half too pessimistic. In either case, the difference may disappoint investors, who can say later that they bought for too much (if the projection was too

d. Particular Statements: Statements in Investment Publications

Plaintiffs also allege that Defendants Clow and the underwriter Defendants made statements to *Dow Jones News Wire*, which statements constitute Rule 10b-5 violations. SAC at ¶ 66.

In addition to the argument concerning scienter, the underwriter Defendants argue that: (1) they cannot be held responsible for Clow's statements; (2) they cannot be held liable for the contents of investment publications over which they had no control; and (3) they were not obliged to make full, prospectus-like disclosures of risk in those investment publications.

There are two reasons why this allegation fails to state a claim. First, Plaintiffs have again failed to allege facts showing scienter, i.e., facts showing that Clow or Montgomery and Alex. Brown knew their statements were false when made, or that they were reckless with regard to their truthfulness. For these reasons, the statements to investment publications do not support a Rule 10b-5 violation as against either Clow, Stac, the other individual named Defendants *or* the underwriter Defendants *or* the venture capital Defendants.

Second, because the instant action is based on a "fraud on the market" theory, and because this Court has found either that the Prospectus adequately disclosed risks concerning Stac, or that Stac was not required to

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optimistic) or sold for too little (if the projection turns out to be too pessimistic)." *Wielgos v. Commonwealth Edison Co.*, 892 F.2d 509, 514 (7th Cir. 1989).

make disclosures, neither the underwriter Defendants nor Clow was obliged to repeat these disclosures when they spoke to the press. Therefore these allegations do not state a cause of action for misleading omissions under Rule 10b-5, against either Stac and the individual named Defendants *or* the underwriter Defendants or the venture capital Defendants.

7. Other Allegations: Violations of SEC and Exchange Rules

Plaintiffs argue that Defendants are also liable – although they do not specify the Section, 11 or 10b – for violation of Item 303 of Regulation S-K, 17 C.F.R. § 229.303 *et seq.*. SAC at ¶ 29(g).

The fundamental flaw with this allegation is similar to the flaws in the allegations above. As the previous discussion makes clear, the Prospectus *did* disclose the existence of known uncertainties that were reasonably likely to have a material effect on Stac's sales, revenues, and income, or Stac was not required to make the disclosures.

There is an additional flaw in Plaintiffs' argument. Item 303(a) applies only to annual reports filed on Form 10-K with the SEC. *Alfus v. Pyramid Technology Corp.*, 745 F. Supp. 1511, 1517 (N.D. Cal. 1990). The alleged omission did not occur in Stac's Form 10-K. Courts have stated that omitting Item 303(a) information from documents other than Form 10-K does not violate Rule 10b-5. *Id.* (citing further cases). In addition, omitting Item 303(a) information from a Prospectus does not violate Section 11. *Verifone*, 784 F. Supp. at 1483. Similarly, violation of exchange

rules will not support a private claim. *Verifone*, 11 F.3d at 870.

D. Violation of Section 20 of the Exchange Act

Section 20 of the Exchange Act states that

> Every person who, directly or indirectly, controls any person liable under any provision of this Act or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable. . . .

15 U.S.C. § 78t(a). Hence Section 20 extends liability under Rule 10b-5 to so-called controlling persons: persons who control those found liable under Rule 10b-5 are also liable to plaintiffs.

The elements for control person liability are: (1) actual power or influence over the controlled person; and (2) culpable participation by the defendant in the illegal activity. *Lubin*, 688 F. Supp. at 1450. The Plaintiff must allege facts tending to show these elements.

Liability under Section 20 is predicated on a violation of Rule 10b-5. Here Plaintiffs fail to state a Rule 10b-5 claim, for the reasons given above. Therefore Count IV of their Complaint – charging control person liability against the individual named Defendants – is also dismissed.

E. Conspiracy, Aiding and Abetting and "Concerted Action"

Plaintiffs also allege conspiracy, aiding and abetting, and "concerted action" with respect to the 10b-5 violations.

1. Concerted Action

This Court is not aware that there is any theory of secondary liability named "concerted action." Nor have Plaintiffs identified such a theory. Hence those allegations are dismissed.

2. Aider and Abettor Liability Under Rule 10b-5

The Supreme Court has clarified this issue: there is no private cause of action for aiding and abetting a Rule 10b-5 violation. *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, No. 92-854, 1994 WL 132212 (April 19, 1994). Hence those allegations are dismissed, as against all Defendants.

3. Conspiracy to Commit Rule 10b-5 Violation

Under Rule 10b-5, the elements for secondary liability for conspiracy are: (1) an agreement to participate in an unlawful act; and (2) injury caused by an overt act in furtherance of the agreement. A plaintiff must plead facts showing an agreement and facts showing injury caused by an overt act in furtherance of the conspiracy. *MDC*, 754 F. Supp. at 797.

Here, because Plaintiffs have not stated a claim under Rule 10b-5, they have not successfully alleged an injury. *Alfus*, 745 F. Supp. at 1521. Therefore Plaintiffs' allegations of conspiracy to commit Rule 10b-5 violations are dismissed, as against all Defendants.

F. Summary

This Court grants Defendants' motion to dismiss Claims I and II of the SAC, based on Section 11 and Section 15 of the Securities Act. It also grants Defendants' motion to dismiss Claims III and IV of the SAC, those based on Rule 10b-5 and Section 20 of the Exchange Act. In addition, it grants Defendants' motion to dismiss the allegations of "concerted action," aiding and abetting, and conspiracy to commit the above violations.

Finally, Plaintiffs' counsel are experienced securities litigators. They have had ample opportunity to correct the deficiencies in the complaint. Meanwhile, the costs of litigation mount.

Therefore Plaintiffs' complaint is dismissed, with prejudice.

IT IS SO ORDERED.

Date: 6/29/94

/s/ John S. Rhoades, Sr.
JOHN S. RHOADES, SR.
UNITED STATES
DISTRICT JUDGE

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UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF CALIFORNIA

TIMOTHY J. ANDERSON, NEIL SINGER, and ARTHUR SINGER, on Behalf of Themselves and All Others Similarly situated, Plaintiffs, v. GARY W. CLOW, DOUGLAS L. WHITING, ROBERT W. JOHNSON, ARTHUR J. COLLMEYER, STAC ELECTRONICS, ALEX. BROWN & SONS, INC. AND MONTGOMERY SECURITIES Defendants. In re STAC ELECTRONICS SECURITIES LITIGATON	CIVIL NO. 92-1120-R ORDER GRANTING DEFENDANTS' MOTION TO DISMISS

The instant class action suit was brought for violations of the securities laws.

There are four counts to the Complaint. Count I, against all Defendants, is for violation of Section 11 of the Securities Act. Count II, against the named individual Defendants, charges controlling person liability under Section 15 of the Securities Act. Count III, against all Defendants, is for violation of Section 10(b) of the Exchange Act and Rule 10b-5 of the Securities and Exchange Commission. Count IV, against the named individual Defendants, charges controlling person liability under Section 20(a) of the Exchange Act.

The Complaint also alleges aiding and abetting and conspiracy to commit the above securities violations.

Defendants move to dismiss the Complaint.[1]

I. Background

At the time of the events giving rise to this lawsuit, Defendants Clow, Whiting, Johnson, and Collmeyer were officers or directors of Stac Electronics.[2] Stac produces computer products: in particular, it sells a device – the aptly named Stacker – which compresses computer data. Complaint at ¶ 4. Compression increases a computer's capacity for storing data. Complaint at ¶ 9.

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[1] Plaintiffs request this Court to take judicial notice of the Answer of Microsoft Corporation and Amended Counterclaim in *Stac Electronics v. Microsoft Corp.*, Civ. No. C-93-0413-LGB(GHKx), filed April 5, 1993.

That request is denied: a motion to dismiss is decided on the pleadings. (As noted below, however, in this case the pleadings include documents incorporated by reference into the Complaint.)

The underwriter Defendants – Alex. Brown & Sons, Inc. and Montgomery Securities – also request this Court to stay discovery.

Because this Court grants the motion to dismiss, and because complaints are not to be used as a "pretext for the discovery of unknown wrongs," *Semegen v. Weidner*, 780 F.2d 727, 731 (9th Cir. 1985), that request is granted.

[2] Clow was Chairman of the Board and Chief Executive Officer; Whiting was Vice President of Technology and a director; Johnson and Collmeyer were directors. Complaint at ¶ 10.

Before it went public, Stac's performance was mixed: it reported net losses per share in 1988, 1989, and 1990, and a net income per share of $.01 in 1991. It also reported revenues hovering around three quarters of a million dollars for 1988 and 1989, with increased revenues in 1990 (to $1.7 million) and 1991 (to $8.3 million). Prospectus at 3.[3]

There was a pronounced move upward – in both revenues and earnings per share – immediately prior to the initial public offering of Stac stock. While Stac reported revenues of $2.3 million and a loss of $.04 per share in the six months prior to March 31, 1991, it reported revenues of $17 million and earnings of $.21 per share in the six months prior to March 31, 1992. Complaint at ¶ 28. Stac attributed the increased revenues and earnings for the 1992 six month period to sales of Stacker. Complaint at ¶ 29.

On May 7, 1992, Stac went public, with an initial offering of 3,000,000 shares of common stock. The stock

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[3] This Court can look to the Prospectus because it is referred to and quoted extensively by Plaintiffs in their Complaint. Therefore it can be treated as part of the pleadings for purposes of a motion to dismiss. *Townsend v. Columbia Operations*, 667 F.2d 844, 848 (9th Cir. 1982); *In re Seagate Technology II Sec. Litig.* [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,502 at 93,201 (N.D. Cal. May 3, 1989). Similarly, because Plaintiffs' Complaint refers to and quotes the analysts' reports of the underwriter Defendants, this Court can treat those documents as part of the pleadings for the purposes of the motion to dismiss. *In re Sun Microsystems. Inc. Securities Litigation* [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,504, at 97,636 (N.D. Cal. Aug. 20, 1990).

was sold to the public at $12.00 a share, with the individual named Defendants selling some 508,000 shares. Complaint at ¶¶ 33, 44. Defendants Alex. Brown & Sons, Inc. and Montgomery Securities acted as co-managing underwriters for the offering; they and the other underwriters purchased for resale all of the Stac stock offered. Complaint at ¶ 33.

In connection with the initial public offering, Stack [sic] issued a Registration Statement and Prospectus ("Prospectus"), dated May 7, 1992. In addition to the financial information noted above, the Prospectus contained extensive discussion of the risks which Stac posed to investors, as well as the competitive environment Stac faced. The Prospectus also discussed Stac's policies concerning distributors, product returns, and allowances for reserves to cover those returns.

The public received statements about Stac from sources other than the Prospectus. Plaintiffs allege, for example, that officers of Stac (including Clow) and representatives of Alex. Brown made "roadshow" presentations, where they projected increased revenues and earnings in the second half of 1992. Complaint at ¶ 34. Similarly, Plaintiffs allege that, following the initial public offering, various analysts' reports portrayed Stac as a good investment. Complaint at ¶¶ 35-37.[4]

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[4] These reports included a June 2, 1992 report from Alex. Brown and a June 2, 1992 report from Montgomery. Complaint at ¶¶ 36, 37.

The Complaint alleges that the Alex. Brown report projected revenues of $43.5 million and earnings of $.55 per share for Stac in fiscal 1992. These projections included

For a short time, those portrayals seemed accurate. Following the offering, Stac climbed to $15 per share. Complaint at ¶ 38. But Stac could not maintain that price per share. On July 2, 1992, on the heels of another computer software company's announcement of poor third quarter results, Stac's stock price fell. Clow, Montgomery, and Alex. Brown, however, all made statements to *Dow Jones News Wire* distinguishing Stac from the other, faltering computer software company. Complaint at ¶ 38.[5]

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revenues of $12 million and earnings of $.15 per share for the quarter ended June 30, 1992, and revenues of $14.5 million and earnings of $.18 per share for the quarter ended September 30, 1992. Complaint at ¶ 36.

Similarly, the Complaint alleges that Montgomery projected earnings of $.55 per share for Stac in fiscal 1992, with revenues of $13 million and earnings of $.16 per share for the third quarter of 1992. Complaint at ¶ 37.

The Complaint also alleges that the information contained in these reports was obtained from Stac or based on information obtained from Stac, and that copies of drafts of these reports were provided to Stac before they were released. Complaint at ¶¶ 36, 37. Plaintiff also alleges that, because Stac knew of the contents of these reports, Stac knew that they would "impact" the price of Stac stock. Complaint at ¶¶ 36-37.

[5] Similarly, after Montgomery reduced its stock rating and earnings estimate for Stac on July 6, 1992, Montgomery told *Dow Jones News Wire* that its report was not reflective of specific worries about Stac, that Stac had not stuffed its distribution channel, and that Stac's revenue recognition policies were conservative. Complaint at ¶ 39.

In contrast to Montgomery, Alex. Brown did not reduce its rating of Stac: it maintained its strong buy recommendation and current estimates of future earnings. Complaint at ¶ 39.

On July 20, 1992, Stac disclosed its third quarter performance. It was disappointing, at least compared to earlier projections.[6] On July 21, 1992, Stac stock declined to $5.50 per share. Complaint at ¶¶ 40, 41.

Predictably, the following day there was a lawsuit: Plaintiffs filed the first of its claims later consolidated in the instant action.

Plaintiffs filed their Consolidated Amended Class Action Complaint on December 4, 1992. Both the individual named Defendants and the underwriter Defendants filed motions to dismiss on February 8, 1993.

II. Applicable Law in Motions to Dismiss

On a motion to dismiss for failure to state a claim upon which relief can be granted under Rule 12(b)(6), the complaint is construed in the light most favorable to the plaintiff, and its allegations are taken as true. *Jenkins v. McKeithen*, 395 U.S. 411, 421-22 (1969); *McKinney v. De Bord*, 507 F.2d 501, 503 (9th Cir. 1974). In reviewing a complaint, a court should let the claims stand "unless it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief." *Conley v. Gibson*, 355 U.S. 41, 45 (1957).

III. Discussion

Plaintiffs' allegations are summarized in ¶ 43 of the Complaint. Plaintiffs aver that the Prospectus and the roadshow presentations, analysts' reports, and statements

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[6] See note 4 above.

in investment publications were materially false and misleading because they misrepresented or failed to disclose:

(a) that Stac had stuffed its distribution channel on the quarter ended March 31, 1992 with Stacker 2.0 to inflate sales and thereby enhance the marketability and price of its stock in the Offering;

(b) that the profitability of Stac, sales of Stacker and costs of sales of Stacker for the quarter ended March 31, 1992 were materially misrepresented in the Prospectus;

(c) that as a result of the overshipments in the March quarter, distributors had excessive inventories of Stacker products which could and would be returned;

(d) that Stac had failed to establish adequate reserves for returned Stacker products or obsolete inventory;

(e) that demand for Stacker 2.0 was being severely diminished by the emergence of competitive products and by anticipation that new software programs to be introduced by market leaders including, *inter alia*, Microsoft's DOS.6, would include data compression, making Stacker obsolete;

(f) that Stac failed to disclose, as required by rules and regulations promulgated by the SEC (including, *inter alia*, Item 303 of Regulation S-K, 17 C.F.R. § 229.303, *et seq.*), the existence of "known trends or any known demand, commitments, events or uncertainties" at Stac that would "result in or that are reasonably likely" to have a material impact on the Company's net

> sales, revenues, income from operations or liquidity; and
>
> (g) that there was no reasonable basis for defendants' projections made during the Class Period of continued and sequential quarterly growth and earnings in the second half of fiscal 1992.[7]

A. Section 11 of the Securities Act

Section 11 of the Securities Act creates a private remedy for any purchaser of a security if any part of the registration statement,

> when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading. . . .

15 U.S.C. § 77k(a).

A Section 11 claim can be asserted against every person who signed the prospectus, the issuer's officers and board of directors, the underwriters of the securities offering, and any expert whose profession gives authority to that part of the registration statement he or she prepared. *Id.*

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[7] As discussed below, (g) does not apply to the Section 11 cause of action. Section 11 concerns misrepresentations or omissions in a registration statement. Here the Prospectus-which also served as the registration statement – is not alleged to contain projections of continued and sequential quarterly growth.

By its terms Section 11 concerns only registration statements. In the instant action, therefore, the roadshow presentations, analysts' reports, and statements to investment publications cannot support a Section 11 claim.

Section 11 addresses both positive misrepresentations and omissions. A Section 11 claim can assert that the Prospectus was defective either: (1) because it contained untrue statements of material fact; or (2)(a) because it omitted required statements of material fact, or (b) because it omitted statements of material fact *necessary to make statements contained in the Prospectus not misleading.*

Here, Plaintiffs allege both misrepresentations and omissions. Their allegations under Section 11 can be categorized as follows.

First, there are purported omissions. As summarized in ¶ 43 of the Complaint,[8] the purported omissions concerned: (1) Stac stuffing its distribution channel in the quarter ended March 31, 1992 (*see also* ¶¶ 4 and 31); (2) Stac distributors having inventories of Stacker products that could and would be returned (*see also* ¶¶ 4 and 31); (3) the adequacy of Stac's reserves for returned Stacker products or obsolete inventory (*see also* ¶¶ 4 and 31); (4) the effect of competition – especially from Microsoft – on demand for Stacker products (*see also* ¶¶ 4 and 32); and (5) information required by Item 303 of Regulation S-K.

The Complaint fails to identify how the Prospectus was *required* to state the first four purported omissions. Therefore this Court takes the Complaint as averring that

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[8] See ¶ 43 (a), (c), (d), (e), and (f).

those omissions were necessary to make other statements contained in the Prospectus not misleading.

Second, the Complaint seemingly offers the allegation contained in ¶ 43(f) – that the Prospectus omitted information required by Item 303 of Regulation S-K – as a purported omission which the Prospectus was required to state.

Third, there are allegedly untrue statements: they concern the profitability of Stac, sales of Stacker, and costs of sales of Stacker for the quarter ended March 31, 1992. Complaint at ¶ 43(b).

1. Purported Omissions Necessary to Make Statements Not Misleading

Plaintiffs allege that the Prospectus failed to include material facts necessary to make statements contained in the Prospectus not misleading. Opposition at 12, lines 9-10. Defendants move to dismiss Count I of the Complaint on the ground that the Prospectus actually disclosed the purported omissions. This Court agrees with Defendants.

As a preliminary matter, Plaintiffs generally fail to identify exactly which statements *in the Prospectus* were misleading because of the purported omissions.[9] The

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[9] Plaintiffs often fail to distinguish between statements contained in the Prospectus and statements made outside its confines. *See especially* Complaint at ¶¶ 4 (p. 2, lines 23-26) and 43. As a consequence, Plaintiff's Section 11 claims are murky.

most likely candidates, however, are the statements cursorily identified in ¶ 43(b): statements concerning Stac's profitability, sales of Stacker, and costs of sales of Stacker- for the quarter ended March 31, 1992.[10]

This Court finds that reading the Prospectus establishes, first, that the purported omissions were actually disclosed. And "[i]f the material containing the alleged omissions actually discloses the facts that Plaintiffs claim

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Complaints have been dismissed for failure to identify which statements contained in the registration statement were made misleading by omissions. *In re Union Carbide Class Action Securities Litigation*, 648 F.Supp. 1322, 1326 (S.D.N.Y. 1986).

For purposes of Section 11, moreover, alleged omissions are actionable only if they are required to be stated in the Prospectus, or if they are necessary to make statements in the Prospectus not misleading. Hence, for purposes of Section 11, it is irrelevant that purported omissions are alleged to be necessary to make statements *outside the Prospectus* not misleading.

[10] In addition, Plaintiffs fail to state *how* the statements identified in ¶ 43(b) were misleading: the theory of Plaintiffs' Complaint, however, seems to be that they were misleading if taken *as indicative of Stac's future performance. See* Complaint at ¶¶ 32, 58.

Insofar as Plaintiffs allege that the statements identified in ¶ 43(b) were misleading if taken as indicative of Stac's future performance, however, Defendants have a convincing reply: the Prospectus also cautioned that "period-to-period comparisons of its operating results should not be relied upon as an indication of future performance." Prospectus at 6.

As the Prospectus explained, Stac had historically experienced significant fluctuations in its operating results, and anticipated that those fluctuations would continue – because of variables such as distributor ordering patterns, for example. *Id.*

are absent, there is obviously no omission." *Sun Microsystems*, at 97,636 (citing *Seagate Technology II*, at 93,201) (dismissing Rule 10b-5 claim alleging omission of material fact necessary to make other statements not misleading).

Second, reading the Prospectus also establishes that the purported omissions were actually disclosed in a way that made the statements concerning the quarter ended March 31, 1992 not misleading. While the meaning of a prospectus is ordinarily a jury question, where "disclosure is so obvious that reasonable minds cannot differ," the adequacy of disclosure can be determined as a matter of law. *Durning v. First Boston Corp.*, 815 F.2d 1265, 1268 (9th Cir. 1987), *cert. denied*, 484 U.S. 944 (1987). The test is a "reasonable investor" test: it asks whether an investor who had been reasonably diligent in reviewing the Prospectus would have been misled – here, as to the statements concerning the quarter ended March 31, 1992. *Id.*[11]

Channel Stuffing. a/k/a Channel Fill

According to Plaintiffs' the Prospectus did not disclose that Stac had stuffed its distribution channel – in other words, that Stac had shipped more product to

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[11] In *Durning*, the district court had determined that the prospectus unambiguously disclosed the dates for the callability of the bonds issued under that prospectus. The Ninth Circuit reversed the district court, finding that the Prospectus was indeed ambiguous on the issue of the bonds' callability. *Id.*

retailers than they could reasonably expect to sell. Complaint at ¶ 4.[12]

Examination of the Prospectus shows, however, that Stac did disclose that its quarterly reports needed to be considered in light of "channel fi11."[13] Stac also made the disclosure in a way that made the Prospectus's statements

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[12] In their Opposition, Plaintiffs assert that Stac *intentionally* shipped products to distributors in order to inflate sales. Opposition at 18, lines 5-6 ("Plaintiffs have alleged that STAC intentionally over-shipped Stacker 2.0, creating a heightened risk of returns"). The implication of that statement is that Stac shipped products on its own initiative.

But the Complaint does not characterize channel stuffing in terms of Stac's intentions or initiative. Rather, the Complaint alleges that Stac shipped "more product to retailers than they could reasonably expect to sell." Complaint at ¶ 4. That characterization of stuffing does not imply that Stac intentionally or on its own initiative overshipped product to retailers. Rather, it is consistent with what Stac disclosed in its Prospectus: that distributors might return products previously ordered, through no fault of Stac's.

Motions to dismiss concern only the allegations contained in the Complaint. *See Alfus v. Pyramid Technology Corp.*, 745 F.Supp. 1511, 1517 (N.D. Cal. 1990). Here the Complaint does not allege that Stac intentionally or on its own initiative shipped to distributors more product than they could reasonably expect to sell.

[13] As Defendants point out, they are not required to use the expression chosen by the Plaintiffs. Defendants were "under no duty to 'characterize the basic underlying facts with pejorative descriptions. . . . ' " *Sun Microsystems*, at 97,637 (citation omitted) (quoting *McMahan & Co. v. Wherehouse Entertainment Co.*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,510 at 93,243 (S.D.N.Y. 1989)).

concerning the quarter ended March 31, 1992 not misleading.

Under the heading "Quarterly Trends," in the section entitled "Management's Discussion and Analysis of Financial Condition and Results of Operations," the Prospectus cautioned that Stac's quarterly results were subject to variation, in part because of channel fill. The Prospectus noted that "[t]he Company's results of operations are subject to significant quarterly variations as a result of a number of factors and risks, including the phenomenon of 'channel fill' during initial shipments of new versions or new products. . . . " Prospectus at 16. Channel fill, the Prospectus explained,

> often occurs following the introduction of a new product or a new version of a product as distributors buy significant quantities of the new product or version in anticipation of sales of such product or version. Following such purchases, the rate of distributor's purchases may decline.

Prospectus at 16. The Prospectus also explicitly stated that Stac had just recently released Version 2.0 of its Stacker product. *Id.* Hence, readers of the Prospectus were alerted to the likelihood that distributors would make fewer purchases of Stacker in the immediate future.

More important, when combined with the explanations of Stac's return policy and its allowance for reserves (discussed below), the disclosures concerning channel fill rendered not misleading the Prospectus's statements concerning the quarter ended March 31, 1992.

Return Policy and Adequacy of Reserves

Plaintiffs also argue that the Prospectus omitted crucial information concerning future returns of Stacker products and the adequacy of Stac's reserves in the face of product returns. Complaint at ¶ 43(c) and (d); *see also* ¶¶ 4 and 31.

Reading the Prospectus, however, shows that it contained statements explaining Stac's return policy. It also cautioned that Stac's allowance for returns might not be adequate. Both these disclosures made the Prospectus's statements of results for the quarter ended March 31, 1992 not misleading.

In the "Risk Factors" section, under the heading "Reliance on Distributors," the Prospectus stated that "[m]ost of the Company's revenues from the Stacker products are realized through distributors that are not under the direct control of the Company." Prospectus at 7. It went on to warn that distributors

> could reduce their support of the Company's products or discontinue carrying the Company's product line, which could have a material adverse effect on the Company's business, operating results and financial condition. Like other manufacturers of packaged software products, the Company is exposed to the risk of product returns from distributors and direct reseller customers.

Id.

At the end of the paragraph, the Prospectus referred the reader to two additional sections – "Management's Discussion and Analysis of Financial Condition and

Results of Operations" and "Business – Marketing and Sales." The latter explained Stac's return policy.

> The Company's return policy allows its distributors to return any new, unused product in the distributor's inventory within a contractually defined period of 60 days from the notice of discontinuance of any product, or any version of a product, for a credit or cash refund. In addition, distributors may participate quarterly in a stock balancing program which, subject to certain limitations, allows them to return purchased products within the second month of each calendar quarter for full credit towards future purchases.

Prospectus at 22.

An additional risk connected with Stac's return policy involved the possibility that the Company might not make adequate allowance for returns. The Prospectus stated that

> [a]lthough the Company believes that it provides adequate allowances for returns, there can be no assurance that actual returns in excess of recorded allowances will not result in a material adverse effect on business. . . .

Prospectus at 7. The Prospectus did state that "[t]o date, product returns have not had a material effect on the Company's results of operations in any period." *Id.* But as the previously quoted language indicates, that did not mean that Stac assured its investors that product returns could not exceed allowances in the future.

In sum, because the Prospectus explained Stac's return policy, and cautioned that actual returns might

exceed allowances, the purported omissions were included in the Prospectus. In addition, the disclosures made the statements concerning the quarter ended March 31, 1992 not misleading.

Microsoft Looming

Plaintiffs also allege that Stac failed to disclose the effect of competition – especially imminent competition from Microsoft – on demand for Stacker products.

This Court finds that the Prospectus disclosed the effect of competition; it also did so in a way that made the reported quarterly results not misleading.

Under the heading "Competition," the Prospectus noted that the market for Stac's products was intensely competitive. "A number of competitors offer products that currently compete with . . . the Company's products," the Prospectus stated; and competitors might successfully offer products "that could render obsolete or adversely affect sales of the Company's products." Prospectus at 5.

The Prospectus observed that a number of Stac's competitors had more resources than Stac. Further, while most of Stac's revenues derived from sales of products that operated under Microsoft's MS-DOS system (i.e., from sales of Stacker), "there can be no assurance that Microsoft . . . will not incorporate a competitive data compression technology in their products or that such a technology will not otherwise emerge as an industry standard." Prospectus at 5.

The Prospectus also noted that Stac licensed and intended to license portions of its core technology to other companies. In turn, those other companies might increase the competition Stac faced. The upshot, the Prospectus continued, was that "[i]ncreased competition could result not only in a decline in sales volume but also in price reductions that could have a material adverse effect on the Company's business. . . . " Prospectus at 5.

Purported Omissions Necessary to Make Statements Not Misleading: Summary

This Court concludes that each of the purported omissions was disclosed in the Prospectus. And when considered together, the disclosures concerning channel fill, product returns, allowances for reserves, and competition rendered the statements of the March 31, 1992 quarterly results not misleading.

There is an additional reason for dismissing Count I of the Complaint. Insofar as Plaintiffs suggest that the March 31, 1992 quarterly results were rendered misleading by later events-such as product returns greater than allowed for – they fail to state a claim. "Section 11 by its terms applies to material misstatements and omissions in the registration statement 'when such part became effective.' Accordingly, when subsequent events make an effective registration statement misleading, section 11 does not apply." *Hazen, Treatise on the Law of Securities Regulation*, 2nd ed. (Practitioner's Edition), Vol. 1, at 294.

Prospectus as a Whole

The above sections show that the Prospectus disclosed the particular material facts, purportedly omitted, which were necessary to make statements concerning the quarter ended March 31, 1992 not misleading. This Court finds that the Prospectus also included other statements which rendered the Prospectus *as a whole* not misleading.

First, Stac prominently characterized its stock as having a "high degree of risk." Prospectus at 3. Second, Stac did not simply rely on a general statement about risk: the Prospectus also contained a lengthy and detailed section entitled "Risk Factors." Prospectus at 5ff. Indeed, that section was the *first* to appear in the body of the Prospectus, after a section describing the company. Third, as discussed immediately above, each of the allegedly omitted facts was disclosed in the Prospectus, either in the Risk Factors section or in other sections to which the discussion in the Risk Factors section explicitly referred the reader.

In addition, the Prospectus repeatedly cautioned that Stac's quarterly results fluctuated, so that "period-to-period comparisons of its operating results should not be relied upon as an indication of future performance." Prospectus at 6. Insofar as Plaintiffs suggest that the Prospectus was misleading if taken as indicative of Stac's future performance, the statements concerning quarterly fluctuations adequately warned investors against relying on such comparisons.

Similarly, the Prospectus disclosed the dependence of Stac on Stacker products, and noted that rapidly changing technology "could render existing products obsolete

and unsalable." Prospectus at 5, 6. Because of these and other factors, the Prospectus continued, the "[m]arket price of the shares of Common Stock . . . is likely to be highly volatile." Prospectus at 8.

2. Purported Omission Required to be Stated Under Regulation S-K

Plaintiffs allege not only that the Prospectus omitted to state material facts necessary to make included statements not misleading, they also allege that the Prospectus omitted to state material facts required to be stated. In particular, they allege that the Prospectus did not disclose

> the existence of "known trends or any known demand, commitments, events or uncertainties" at Stac that would "result in or that are reasonably likely" to have a material impact on the Company's net sales, revenues, income from operations or liquidity.

Complaint at ¶ 43(f). Plaintiffs argue that Item 303 of Regulation S-K, 17 C.F.R. § 229.303 *et seq.*, required such disclosure. *Id.*

The fundamental flaw with this allegation is similar to the flaws in the allegations above. As the previous discussion of channel stuffing (or channel fill), return policy, adequacy of reserves, and threat of competition makes clear, the Prospectus *did* disclose the existence of known uncertainties that were reasonably likely to have a material effect on Stac's sales, revenues, and income.

There is an additional flaw in Plaintiffs' argument. Item 303(a) applies only to annual reports filed on Form 10-K with the SEC. *Alfus*, 745 F.Supp. at 1517. The alleged

omission did not occur in Stac's Form 10-K, but rather in its Prospectus. Courts have stated that omitting Item 303(a) information from documents other than Form 10-K does not violate Rule 10b-5. *Id.* (citing further cases). In addition, omitting Item 303(a) information from a Prospectus does not violate Section 11. *In re Verifone Securities Litigation,* 784 F.Supp. 1471, 1483 (N.D. Cal. 1992).

3. Allegedly Untrue Statements of Material Fact

Plaintiffs allege that the Prospectus contained untrue statements of material fact. They assert that "the profitability, sales of Stacker and costs of sales of Stacker for the quarter ended March 31, 1992 were materially misrepresented in the Prospectus." Complaint at ¶ 43(b).[14]

The allegation at ¶ 43(b), however, simply summarizes the Plaintiffs' allegations previously discussed. This Court has found that the purported omissions were actually disclosed, and that they were disclosed in a way that made the statements concerning the quarter ended March 31, 1992 not misleading. Because the allegation at ¶ 43(b) is simply a summary of allegations which are themselves

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[14] Plaintiffs allege that these financial statements-concerning profitability, sales of Stacker and costs of sales of Stacker for the quarter ended March 31, 1992 – were generated in violation of Generally Accepted Accounting Principles, including Accounting Research Bulletin No. 43, Chapter 4 and Statement of Financial Accounting Standards No. 48, Paragraph 7. Complaint at ¶ 31. That allegation, however, is simply another way of saying that Stac had not made adequate allowances for returns. And this Court has found that Stac's Prospectus adequately disclosed the risk that there would be returns over the amount allowed for.

insufficient to state a claim, it follows that the allegation at ¶ 43(b) is insufficient as well.

Heightened Pleading Standard Where Section 11 Claims Sound in Fraud

There is an additional reason why Plaintiffs' Complaint is deficient: it fails to plead the circumstances constituting fraud with particularity.

Plaintiffs argue that because they allege violation of Section 11, they need not meet the requirements of Fed. R. Civ. P. 9(b). *See e.g., In re Seagate Technology Sec. Litig.* [198586 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,435 at 92,657658 (N.D. Cal. 1985); *Schneider v. Traweek* [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,507 at 97,662 (C.D. Cal. 1990).

Here, however, the Complaint alleges not just that there were untrue statements or misleading omissions. It alleges that the Prospectus was *fraudulent*. Complaint at ¶ 6 (stating that "by fraudulently presenting inflated second quarter financial results, defendants were able to artificially increase the initial offering price . . . of Stac stock," allowing defendants to sell the stock at huge profits). Indeed, the Complaint alleges the same facts as the basis of both the Section 11 and the Rule 10b-5 claim.

In such cases, as Defendants point out, courts have held that the particularity requirements of Fed. R. Civ. P. 9(b) apply, even though Section 11 plaintiffs need not

prove scienter. *See e.g., Hershey v. MNC Financial, Inc.*, 774 F.Supp 367, 375 (D. Md. 1991).[15]

Here, because their Section 11 claim sounds in fraud, Plaintiffs must plead the circumstances constituting fraud with particularity. They have not done so. The allegation that the Prospectus contains fraudulent financial statements, for example, is a bare conclusion, with no factual basis pleaded in its support.[16] And to the extent that Plaintiffs contend that the quarterly results were misrepresented because of channel fill, return policy, adequacy

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[15] The court in *Hershey* explained:

> The mere fact that plaintiffs need not prove scienter to recover under §§ 11 and 12(2) does not mean that §§ 11 and 12(2) claims can never "sound in fraud." On the contrary, a plaintiff may allege [under those sections] a scheme which, if proven, would constitute fraud. That is precisely what plaintiffs have done here. The gist of their claims is that [defendant] embarked upon a scheme fraudulently to overstate its financial health. . . . While they have invoked §§ 11 and 12(2) as legal bases for these claims, the gravamen of their case is fraud.
>
> . . . . [Rule 9(b)'s] application should depend on the substance of a plaintiff's allegations, not upon the guise in which he portrays them.

Id. at 375-76.

[16] In addition, virtually all of Plaintiffs' allegations are made on "information and belief." The general rule is that such allegations do not satisfy Rule 9(b). *McFarland v. Memorex Corp.*, 493 F.Supp. 631, 638-639 (N.D. Cal. 1980). Even where the allegations concern matters peculiarly within the adverse parties' knowledge, the plaintiff must "allege sufficient factual detail to demonstrate that his complaint is grounded in *some* facts." *Id.* at 639.

of reserves, and effect of competition, the previous discussion has rejected those arguments.

The "Bespeaks Caution" Doctrine Does Not Apply

Defendants also argue that the Complaint fails to state a cause of action under Section 11 because the Prospectus "bespeaks caution."

Technically, the bespeaks caution doctrine "holds that when a prospectus contains substantial disclosure of specific risks, statements that express management's optimism about future performance, despite those particular risks, are not misleading as a matter of law." *In re Worlds of Wonder Securities Litigation*, slip op., No. C 87-5491 (N.D. Cal. January 20, 1993), at 9-10.

There are limits to the bespeaks caution doctrine, however. The first is that it "applies only to precise cautionary language which directly addresses itself to future projections, estimates or forecasts in a prospectus." *In re Donald Trump Casino Securities Litigation*, 793 F.Supp. 543, 554 (D. N.J. 1992). A second limit is that the doctrine "does not apply to immunize false statements if the defendants knew the statements were false when made." *WOW*, at 15.

Here, despite a Prospectus that fairly bristles with cautionary language, the bespeaks caution doctrine simply does not apply – for the very good reason that the Prospectus contains no projections, estimates or forecasts which are at issue. The alleged misrepresentations and purported omissions do not pertain to projections about

the future, but rather to the Prospectus's reporting of results for the quarter ended March 31, 1992.

Summary of Section 11 Claims

Because the Prospectus actually discloses the purported omissions, and because it discloses them in ways that make the Prospectus's statements concerning the quarter ended March 31, 1992 not misleading, the Section 11 allegations based on purported omissions of material facts are dismissed. And because the allegation at ¶ 43(b) simply summarizes allegations which are themselves insufficient, the Complaint does not adequately allege that the Prospectus contained untrue statements. Hence this Court finds that Count I of the Complaint fails to state a claim upon which relief can be granted, as against both Stac and the individual named Defendants *and* the underwriter Defendants.

B. Violation of Section 15 of the Securities Act

Plaintiffs charge that the individual named Defendants are also liable under Section 15 of the Securities Act. Section 15 of the Securities Act states that

> Every person who, by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls any person liable under sections 77k or 771 of this title, shall also be liable jointly and severally with and to the same extent as such controlled person. . . .

15 U.S.C. 78t. Hence Section 15 extends liability to so-called controlling persons:[17] persons who control those found liable under Section 11 are also liable to plaintiffs.

Liability under Section 15 is thus predicated on finding a violation of Section 11. Here Plaintiffs do not state a claim under Section 11, for the reasons given above. Therefore the motion to dismiss Count II of the Complaint is granted.

C. Violation of Section 10(b) of the Exchange Act and Rule 10b-5 of the Securities and Exchange Commission

1. Legal Standard: Statute and Rule

Section 10(b) of the Exchange Act provides that "it shall be unlawful for any person . . . to use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe." 15 U.S.C. § 78j(b).

Securities and Exchange Commission Rule 10b-5, promulgated under authority of Section 10(b), further provides:

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[17] In *Wanetick v. Mel's of Modesto, Inc.*, 811 F.Supp. 1402, 1407 (N.D. Cal. Dec. 15, 1992), the court defined "control" as follows: "a person controls an individual or entity if he or she possesses, directly or indirectly, 'the power to direct or cause the direction of management and policies of a person, whether through ownership of voting securities, by contract or otherwise.' " *Id.* at 1407 (citing 17 C.F.R. § 230.405).

> It shall be unlawful for any person. . . .
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statement made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

17 C.F.R. § 240.10(b)(5).

The Supreme Court has also held that for a defendant to be liable under Rule 10b-5, there must be a showing of scienter, defined as a "mental state embracing intent to deceive, manipulate, or defraud." *Ernst & Ernst v. Hochfelder,* 425 U.S. 185, 194 and n.12 (1976). The Ninth Circuit, however, has held that scienter can be proved by a showing of recklessness on the part of the defendant. *Hollinger v. Titan Capital Corp.,* 914 F.2d 1564, 1568-69 (9th Cir. 1990), *cert. denied,* 111 S.Ct. 1621 (1991).[18]

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[18] For the purposes of Rule 10b-5, reckless conduct is defined as conduct

> involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers and sellers that is either

2. Legal Standard: Pleading Fraud With Particularity

Because Rule 10b-5 claims sound in fraud, they must meet the particularity requirements of Fed. R. Civ. P. 9(b). *Wool v. Tandem Computers, Inc.*, 818 F.2d 1433, 1439 (9th Cir. 1987); *see generally*, Hazen, *Securities Regulation*, Vol. 2, at 66.

Fed. R. Civ. P. 9(b) states that "[i]n all averments of fraud and mistake, the circumstances constituting fraud and mistake shall be stated with particularity. Malice, intent, knowledge, and other condition of mind of a person may be averred generally."

The Ninth Circuit has interpreted Rule 9(b) to mean that "the pleader must state the time, place, and specific content of the false representations as well as the identities of the parties to the misrepresentation." *Schreiber Distributing v. Serv-Well Furniture Co.*, 806 F.2d 1393, 1401 (9th Cir. 1986) (citing *Semegen*, 780 F.2d at 731).

Rule 9(b) is meant not only to enable defendants to respond to the complaint. It is also meant to accomplish three other goals: first, to prevent complaints from being used as a "pretext for the discovery of unknown wrongs;" second, to protect "potential defendants – especially professionals whose reputations in their fields of expertise are most sensitive to slander – from the harm that comes from being charged with the commission of fraudulent

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known to the defendant or is so obvious that the actor must have been aware of it.

Id. at 1569 (quoting *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1045 (7th Cir. 1977), *cert. denied*, 434 U.S. 875 (1977)).

acts;" and third, "to prohibit a plaintiff from unilaterally imposing upon the court, the parties and society enormous social and economic costs absent some factual basis." *Semegen*, 780 F.2d at 731.

3. Plaintiffs' Legal Theory

The theory of Plaintiffs' Complaint is that Defendants committed a "fraud on the market." A recent Ninth Circuit case explains the fraud on the market theory in the following way:

> In a fraud on the market case, the plaintiff claims that he was induced to trade stock not by any particular representations made by corporate insiders, *but by the artificial stock price set by the market in light of statements made by the insiders as well as all other material public information.*

In re Apple Computer Securities Litigation, 886 F.2d 1109, 1114 (9th Cir. 1989), *cert. denied*, 496 U.S. 943 (1990) (emphasis added).

To prevail in a fraud on the market case, "the plaintiffs must demonstrate that a particular statement, *when read in light of all the information then available to the market*, or a failure to disclose particular information, conveyed a false or misleading impression." *In re Convergent Technologies Securities Litigation*, 948 F.2d 507, 512 (9th Cir. 1991) (emphasis added).

4. The Allegations

Here Plaintiffs make the same allegations concerning the Prospectus as for the Section 11 violation. In addition, they make allegations concerning roadshow presentations, analysts' reports, and statements to investment publications.

a. Particular Statements: The Prospectus

This Court has already discussed the purported omissions from the Prospectus. It has found that the purported omissions were actually disclosed. It has also found that the disclosures made the statements concerning the March 31, 1992 quarter not misleading.[19]

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[19] There is a further reason why the purported omission identified in ¶ 43(e) fails to state a claim under the "fraud on the market" theory. That purported omission concerned the demand for Stacker being severely diminished by emergence of new competitive products and *"by anticipation that new software programs* [from Microsoft, among others] would include data compression. . . . " Complaint at ¶ 43(e) (emphasis added).

But that allegation itself betrays that the information concerning Microsoft's entrance into the data compression business was *already available* to the market. "[I]n a fraud on the market case, the defendant's failure to disclose material information may be excused where that information has been made credibly available to the market by other sources." *Apple Computer Securities*, 886 F.2d at 1115.

Here not only did the Prospectus disclose the fact that Stac faced stiff competition, including competition from Microsoft. In addition, the market was already apprised of that fact – as Plaintiffs' allegation itself reveals.

This Order has also discussed the allegation of untrue statements. That allegation was also insufficient, both because it simply summarized the allegations concerning purported omissions, which were themselves insufficient, and because the Complaint fails to comply with the requirements of Fed. R. Civ. P. 9(b).

Stac and the individual named Defendants move to dismiss the Rule 10b-5 claims arising from the Prospectus on the additional ground that Plaintiffs fail to plead any facts giving rise to an inference of scienter.

The underwriter Defendants move to dismiss the Rule 10b-5 claims stemming from the Prospectus on two grounds: first, they argue – along with Stac and the individual named Defendants – that the Complaint fails to allege facts supporting an inference of their scienter; and second, they contend that the Complaint fails to identify the specific role of the underwriters in the alleged fraud.

This Court finds that, with respect to the allegedly fraudulent statements contained in the Prospectus, the Complaint fails to state Rule 10b-5 claims against both Stac and the individual named Defendants *and* the underwriter Defendants. First, the Complaint is deficient because it fails to allege facts supporting an inference of scienter. Under Fed. R. Civ. P. 9(b), Plaintiffs must plead facts which indicate that Defendants were aware that the statements were false when made, or were reckless concerning their truth or falsity. *Alfus,* 745 F.Supp. at 1519; *Zaltzman v. Clark* [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,603, at 92,842 (N.D. Cal. Mar. 17, 1992), *order modified* [1992 Transfer Binder] Fed. Sec. L. Rep.

(CCH) ¶ 96,897 at 93,964 (N.D. Cal. June 5, 1992); *Hudson v. Capital Management International, Inc.* [1982-83 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,221 at 95,896 (N.D. Cal. 1982).

Second, the Complaint fails to identify the specific role of the Underwriters in propounding the allegedly fraudulent statements contained in the Prospectus. "[I]t is insufficient under Rule 9(b) to 'group [defendants] together without differentiating who might be primarily liable and who might be secondarily liable.' " *Lubin v. Sybedon Corp.*, 688 F.Supp. 1425, 1443 (S.D. Cal. 1988) (citation omitted). Instead, fraud allegations must inform each defendant of the conduct which constitutes the violation. *Id.* (citing *Hokama v. E.F. Hutton & Co., Inc.*, 566 F.Supp. 636, 645 (C.D. Cal. 1983)).

For these reasons, the allegations concerning the statements in the Prospectus are dismissed, for failure to comply with Fed. R. Civ. P. 9(b). The dismissal applies to both Stac and the individual named Defendants *and* the underwriter Defendants.

It remains to consider the so-called roadshow presentations, analysts' reports (including projections of earnings and revenues), and statements in investment publications.

b. Particular Statements: Roadshow Presentations

Plaintiffs allege that Defendant Clow "and other officers of Stac and representatives of Alex. Brown" participated in roadshow presentations to promote the Stac

offering. Plaintiffs also allege that, during those presentations, those Defendants presented projections of consecutive quarters of increased earnings and revenue in the second half of 1992. Complaint at ¶ 34.

These allegations are woefully inadequate under Fed. R. Civ. P. 9(b). While they do specifically identify Defendants Clow and Alex. Brown, they do not specify the time or place of the alleged misrepresentations. *Schreiber*, 806 F.2d at 1401 (citing *Semegen*, 780 F.2d at 731). For these reasons alone, the allegations concerning roadshow presentations are dismissed, as against all Defendants, for failure to state circumstances constituting fraud with particularity.

c. Particular Statements: Analysts' Reports and Projections

Plaintiffs allege that three analysts' reports – one issued by Norman Fosback, the others issued by the underwriter Defendants – also violated Rule 10b-5. Complaint at ¶¶ 35, 36, and 37. According to Plaintiffs' Complaint, the underwriter Defendants, lacked a reasonable basis for their projections of continued and sequential quarterly growth and earnings for Stac in the second half of fiscal 1992. Complaint at ¶¶ 36, 37.

Plaintiffs connect Stac and the individual named Defendants to these projections by averring generally that the information contained in these reports was obtained from Stac or based on information obtained from Stac, and that copies of drafts of these reports were provided to Stac before they were released. *Id.*

Reports and Projections: Stac and the Individual Named Defendants

Stac and the individual named Defendants move to dismiss on two grounds. First, they argue that the allegations that they placed their imprimatur on the analysts' reports are conclusory, and that they had no duty to correct the analysts' reports. Stac and the individual named Defendants also argue that the Complaint alleges no facts indicating that they knew the projections lacked a reasonable basis when made, or were reckless concerning that possibility.

This Court agrees with Stac and the individual named Defendants. First, "[i]n order to be liable for unreasonably disclosed third-party forecasts, defendants must have put their imprimatur, express or implied, on the projections." *Verifone*, 784 F.Supp. at 1486. Here, as in *Verifone*, the Complaint has not stated facts with sufficient particularity to show how the corporate defendants "adopted" the analysts' reports. *Id.* at 1487.

Second, the Complaint has also not stated facts with sufficient particularity to show why the corporate defendants had no reasonable basis to believe that the projections made could come true, or that they knew the projections lacked a reasonable basis. *Id.* at 1486-87. For these reasons, the Rule 10b-5 claim, alleging fraudulent projections in the analysts' reports, is dismissed as against Stac and the individual named Defendants.

Reports and Projections: Underwriter Defendants

The underwriter Defendants move to dismiss on the grounds that they did not make projections of continued

and sequential quarterly growth;[20] that Plaintiffs again allege no facts showing scienter; and that the bare assertion that the projections lacked a reasonable basis when made is insufficient under Rule 9(b).

This Court agrees with the underwriter Defendants. In particular, the bare assertion that the projections lacked a reasonable basis when made is insufficient to satisfy either the scienter requirement of Rule 10(b) or the pleading requirements of Rule 9(b). *Id.* at 1490-91. Plaintiffs must assert facts which show that the underwriter defendants had no reasonable basis for the projections made in the analysts' reports at the time that those reports were published. *Id.* at 1491.[21]

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[20] The underwriter Defendants argue that the Complaint should be dismissed because they did not in fact make projections of continued and sequential quarterly growth and earnings for Stac in the second half of fiscal 1992.

They provided copies of the analysts' reports to this Court; they also argue that the reports should be treated as part of the pleadings because they are referred to and quoted in the Complaint.

This Court need not go that far, because it finds the allegations insufficient on other grounds.

The underwriter Defendants also argue that the Complaint fails to connect them to the report of Norman Fosback. *See* Complaint at ¶ 35. I agree.

[21] As the underwriter Defendants point out, to allow such pleadings to pass muster would be to allow claims every time projections differed at all from results. For, as Judge Easterbrook has noted, "[i]f all estimates are made carefully and honestly, half will turn out too favorable to the firm and the other half too pessimistic. In either case, the difference may disappoint investors, who can say later that they bought for too much (if the projection was too optimistic) or sold for too little (if the

d. Particular Statements: Statements in Investment Publications

Plaintiffs also allege that Defendants Clow and the underwriter Defendants made statements to *Dow Jones News Wire*, which statements constitute Rule 10b-5 violations. Complaint at ¶¶ 38, 39.

The underwriter Defendants argue that: (1) they cannot be held responsible for Clow's statements; and (2) they cannot be held liable for the contents of investment publications over which they had no control; and (3) they were not obliged to make full, prospectus-like disclosures of risk in those investment publications.

This Court agrees with the underwriter Defendants, but for slightly different reasons. First, because the instant action is based on a "fraud on the market" theory, and because this Court has found that the Prospectus adequately disclosed risks concerning Stac, neither the underwriter Defendants nor Clow was obliged to repeat those disclosures. Therefore these allegations do not state a cause of action for misleading omissions under Rule 10b-5, against either Stac and the individual named Defendants *or* the underwriter Defendants.

Second, in any case Plaintiffs have failed to allege facts showing scienter, i.e., facts showing that Clow or Montgomery and Alex. Brown knew their statements were false when made, or that they were reckless with regard to their truthfulness. For these reasons, the statements to investment publications do not support a Rule

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projection turns out to be too pessimistic)." *Wielgos v. Commonwealth Edison Co.*, 892 F.2d 509, 514 (7th Cir. 1989).

10b-5 violation as against either Clow, Stac, the other individual named Defendants *or* the underwriter Defendants.

D. Violation of Section 20 of the Exchange Act

Section 20 of the Exchange Act states that:

> Every person who, directly or indirectly, controls any person liable under any provision of this Act or of any rule of regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable. . . .

15 U.S.C. § 78t(a). Hence Section 20 extends liability under Rule 10b-5 to so-called controlling persons: persons who control those found liable under Rule 10b-5 are also liable to plaintiffs.

The elements for control person liability are: (1) actual power or influence over the controlled person; and (2) culpable participation by the defendant in the illegal activity. *Lubin*, 688 F.Supp. at 1450. The Plaintiff must allege facts tending to show these elements.

Liability under Section 20 is predicated on a violation of Rule 10b-5. Here Plaintiffs fail to state a Rule 10b-5 claim, for the reasons given above. Therefore Count IV of their Complaint – charging control person liability against the individual named Defendants – is also dismissed.

E. Conspiracy, Aiding and Abetting and "Concerted Action"

Plaintiffs also allege conspiracy, aiding and abetting, and "concerted action" with respect to the alleged securities violations.

1. No Conspiracy or Aiding and Abetting Liability for Section 11 Claims

Secondary liability for violations of Rule 10b-5 can attach for conspiracy and for aiding and abetting. The prevailing view is that Section 11, by contrast, does not allow for secondary liability for conspiracy or for aiding and abetting. *McFarland v. Memorex Corp.*, 493 F.Supp. 631, 642 (N.D. Cal. 1980); *see generally*, Hazen, *Securities Regulation*, Vol. 1, at 350 and 353ff. Rather, the statutory list of potential defendants under Section 11 is exclusive. Hazen, *Securities Regulation*, Vol. 1, at 292.

Moreover, this Court is not aware that there is any theory of secondary liability named "concerted action." Nor have Plaintiffs identified such a theory.

Here the Complaint does not distinguish between the allegations of secondary liability – for aiding and abetting or conspiracy – for Section 11 and for Rule 10b-5. Because there is no secondary liability for Section 11, the Complaint fails to state a claim – for aiding and abetting or conspiring to commit a Section 11 violation – upon which relief can be granted.

2. Aider and Abettor Liability Under Rule 10b-5

In order to establish aider and abettor liability, a plaintiff must show: (1) the existence of an independent primary wrong; (2) actual knowledge by the alleged aider and abettor of the wrong and of his or her role in furthering it; and (3) substantial assistance in the wrong. *Lubin*, 688 F.Supp. at 1448 (citing *Harmsen v. Smith*, 693 F.2d 932 (9th Cir. 1982), *cert. denied*, 464 U.S. 822 (1983)). The plaintiff must allege facts supporting a reasonable inference that the defendant had actual knowledge of the primary wrong, and facts indicating that the defendant substantially assisted that primary wrong. *In re MDC Holdings Securities Litigation*, 754 F.Supp. 785, 797 (S.D. Cal. 1990).

Here Plaintiffs have failed adequately to allege the existence of a primary wrong, Rule 10b-5, liability. *Alfus*, 745 F.Supp. at 1520. In addition, Plaintiffs have failed to plead the other elements in anything more than the most conclusory terms. *Id.* Therefore Plaintiffs' aiding and abetting claims are dismissed, as against both Stac and the individual named Defendants *and* the underwriter Defendants.

3. Conspiracy to Commit Rule 10b-5 Violation

Under Rule 10b-5, the elements for secondary liability for conspiracy are: (1) an agreement to participate in an unlawful act; and (2) injury caused by an overt act in furtherance of the agreement; a plaintiff must plead facts showing an agreement and facts showing injury

caused by an overt act in furtherance of the conspiracy. *MDC*, 754 F.Supp. at 797.

Here, because Plaintiffs have not stated a claim under Rule 10b-5, they have not successfully alleged an injury. *Alfus*, F.Supp. at 1521. In addition, Plaintiffs' allegations that Defendants conspired to commit fraud are insufficient both for failure to plead conspiracy with the requisite particularity and for failure to plead an agreement to participate in an unlawful act. *Id.* Therefore Plaintiffs' allegations of conspiracy to commit Rule 10b-5 violations are dismissed, as against both Stac and the individual named Defendants *and* the underwriter Defendants.

F. Summary

This Court grants Defendants' motion to dismiss Counts I and II of the Complaint, based on Section 11 and Section 15 of the Securities Act. It also grants Defendants' motion to dismiss Counts III and IV of the Complaint, those based on Rule 10b-5 and Section 20 of the Exchange Act. In addition, it grants Defendants' motion to dismiss the allegations of aiding and abetting and conspiracy to commit the above violations.

Plaintiffs are given 30 days to amend their complaint.

IT IS SO ORDERED.

Date: 9/17/93

/s/ John S. Rhoades, Sr.
JOHN S. RHOADES, SR.
UNITED STATES
DISTRICT JUDGE

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NOT FOR PUBLICATION

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

In re STAC ELECTRONICS SECURITIES LITIGATION	No. 94-56232
	D.C. No. CV-92-1120-JSR
TIMOTHY J. ANDERSON; NEIL SINGER; ARTHUR SINGER, on Behalf of Themselves and All Others Similarly Situated,	ORDER
	(Filed Aug. 27, 1996)
Plaintiffs-Appellants,	
v.	
GARY W. CLOW; DOUGLAS WHITING; ROBERT JOHNSON; ALEX BROWN & SONS INCORPORATED; LAWRENCE FINCH, et al.,	
Defendants-Appellees.	

Before: WALLACE, FERGUSON, and T.G. NELSON, Circuit Judges.

Judges Wallace, Ferguson and T.G. Nelson have voted to deny appellant's petition for rehearing. Judge T.G. Nelson votes to reject the suggestion for rehearing en banc, and Judges Wallace and Ferguson so recommend.

The full court has been advised of the suggestion for rehearing en banc and no judge of the court has requested a vote on whether to rehear the matter en banc. Fed. R. App. P. 35.

The petition for rehearing is denied and the suggestion for rehearing en banc is rejected.

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

In re: STAC ELECTRONICS SECURITIES LITIGATION, Debtor [sic].	No. 94-56232
TIMOTHY J. ANDERSON, et al., Plaintiffs/Appellants, vs. GARY W. CLOW, et al., Defendants/Appellees.	DC# CV-92-1120-JSR Southern California (San Diego) ORDER (Filed May 11, 1995)

The parties have stipulated to the dismissal of this appeal only as to Defendants Hoff, Crosspoint Venture Partners, and Robelen and Idanta under Fed. R. App. P. 42(b). The appeal is dismissed as to these parties only. The parties shall bear their own costs and fees.

A certified copy of this order sent to the district court shall act as and for the mandate of this court as to the named appellees.

The appeal shall continue as to the remainder of the defendants.

For the Court:

CATHY A. CATTERSON
Clerk of the Court

/s/ Lou Pearson
Lou Pearson
Deputy Clerk

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

In re: STAC ELECTRONICS SECURITIES LITIGATION, Debtor [sic].	
	No. 94-56232
TIMOTHY J. ANDERSON, et al., Plaintiffs/Appellants, vs. GARY W. CLOW, et al., Defendants/Appellees.	DC# CV-92-1120-JSR Southern California (San Diego) ORDER (Filed Apr. 27, 1995)

The parties have stipulated to the dismissal of this appeal only as to Defendants Finch, Sigma Management, Sigma Management II, L.P., & Sigma Partners under Fed. R. App. P. 42(b). The appeal is dismissed as to these parties only. The parties shall bear their own costs and fees.

A certified copy of this order sent to the district court shall act as and for the mandate of this court as to the named appellees.

The appeal shall continue as to the remainder of the defendants.

For the Court:

CATHY A. CATTERSON
Clerk of the Court

/s/ Lou Pearson
Lou Pearson
Deputy Clerk

STATUTES AND RULES

Federal Rule of Civil Procedure 8 (in relevant part):

> *(a) Claims for Relief.* A pleading which sets forth a claim for relief, whether an original claim, counterclaim, cross-claim, or third-party claim, shall contain . . . (2) a short and plain statement of the claim showing that the pleader is entitled to relief, and (3) a demand for judgment for the relief the pleader seeks. Relief in the alternative or of several different types may be demanded.
>
> * * *
>
> *(e) Pleading to be Concise and Direct; Consistency.*
>
> (1) Each averment of a pleading shall be simple, concise, and direct. No technical forms of pleading or motions are required.
>
> (2) A party may set forth two or more statements of a claim or defense alternately or hypothetically, either in one count or defense or in separate counts or defenses. When two or more statements are made in the alternative and one of them if made independently would be sufficient, the pleading is not made insufficient by the insufficiency of one or more of the alternative statements. A party may also state as many separate claims or defenses as the party has regardless of consistency and whether based on legal, equitable, or maritime grounds. . . .

(f) Construction of Pleadings. All pleadings shall be so construed as to do substantial justice.

Federal Rule of Civil Procedure 9(b):

(b) Fraud, Mistake, Condition of the Mind.* In all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity. Malice, intent, knowledge, and other condition of mind of a person may be averred generally.

Securities Act §11, 15 U.S.C. §77k (in relevant part):

Civil Liabilities on Account of False Registration Statement

Sec. 11. (a) In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may, either at law or in equity, in any court of competent jurisdiction, sue –

(1) every person who signed the registration statement;

(2) every person who was a director of (or person performing similar functions) or partner in, the issuer at the time of the filing of the part of the registration statement with respect to which his liability is asserted;

(3) every person who, with his consent, is named in the registration statement

as being or about to become a director, person performing similar functions, or partner;

(4) every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him;

(5) every underwriter with respect to such security.

If such person acquired the security after the issuer has made generally available to its security holders an earning statement covering a period of at least twelve months beginning after the effective date of the registration statement, then the right of recovery under this subsection shall be conditioned on proof that such person acquired the security relying upon such untrue statement in the registration statement or relying upon the registration statement and not knowing of such omission, but such reliance may be established without proof of the reading of the registration statement by such person.

(b) Notwithstanding the provisions of subsection (a) no person, other than the issuer, shall be liable as provided therein who shall sustain the burden of proof –

(1) that before the effective date of the part of the registration statement with respect to which his liability is asserted (A) he had resigned from or had taken such steps as are permitted by law to resign from, or ceased or refuted to act in, every office, capacity, or relationship in which he was described in the registration statement as acting or agreeing to act, and (B) he had advised the Commission and the issuer in writing that he had taken such action and that he would not be responsible for such part of the registration statement; or

(2) that if such part of the registration statement became effective without his knowledge, upon becoming aware of such fact he forthwith acted and advised the Commission, in accordance with paragraph (1), and, in addition, gave reasonable public notice that such part of the registration statement had become effective without his knowledge; or

(3) that (A) as regards any part of the registration statement not purporting to be made on the authority of an expert, and not purporting to be a copy of or extract from a report or valuation of an expert, and not purporting to be made on the authority of a public official document or statement, he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the

statements therein not misleading; and (B) as regards any part of the registration statement purporting to be made upon his authority as an expert or purporting to be a copy of or extract from a report or valuation of himself as an expert, (i) he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or (ii) such part of the registration statement did not fairly represent his statement as an expert or was not a fair copy of or extract from his report or valuation as an expert; and (C) as regards any part of the registration statement purporting to be made on the authority of an expert (other than himself) or purporting to be a copy of or extract from a report or valuation of an expert (other than himself), he had no reasonable ground to believe and did not believe, at the time such part of the registration statement became effective, that the statements therein were untrue or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or that such part of the registration statement did not fairly represent the statement of the expert or was not a fair copy of or extract from the report or valuation of the expert; and (D) as regards any part of the registration statement purporting to be a statement made by an official person or

purporting to be a copy of or extract from a public official document, he had no reasonable ground to believe and did not believe, at the time such part of the registration statement became effective, that the statements therein were untrue, or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or that such part of the registration statement did not fairly represent the statement made by the official person or was not a fair copy of or extract from the public official document.

(c) In determining, for the purpose of paragraph (3) of subsection (b) of this section, what constitutes reasonable investigation and reasonable ground for belief, the standard of reasonableness shall be that required of a prudent man in the management of his own property.

* * *

(e) The suit authorized under subsection (a) of this section may be to recover such damages as shall represent the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and (1) the value thereof as of the time such suit was brought, or (2) the price at which such security shall have been disposed of in the market before suit, or (3) the price at which such security shall be been disposed of after suit but before judgment if such damages shall be less than the damages representing the difference between the amount paid for the security (not exceeding the price at

which the security was offered to the public) and the value thereof as of the time such suit was brought: *Provided, that* if the defendant proves that any portion or all of such damages represents other than the depreciation in value of such security resulting from such part of the registration statement, with respect to which his liability is asserted, not being true or omitting to state a material fact required to be stated therein or necessary to make the statements therein not misleading, such portion of or all such damages shall not be recoverable. . . .

* * *

Securities Exchange Act §10(b), 15 U.S.C. §78j(b):

Regulation of the Use of Manipulative and Deceptive Devices

Sec. 10. It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange –

* * *

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Securities Exchange Act §21D(b), 15 U.S.C. §78u-4(b):

(b) *Requirements for Securities Fraud Actions.* –

(1) *Misleading Statements and Omissions.* – In any private action arising under this title in which the plaintiff alleges that the defendant –

(A) made an untrue statement of a material fact; or

(B) omitted to state a material fact necessary in order to make the statements made, in the light of the circumstances in which they were made, not misleading;

the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed.

(2) *Required State of Mind.* – In any private action arising under this title in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate this title, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.

* * *

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UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF CALIFORNIA

TIMOTHY J. ANDERSON, NEIL SINGER and ARTHUR SINGER, on Behalf of Themselves and All Others Similarly Situated, Plaintiffs, vs.	Master File No. 92-1120-R (BTM) *CLASS ACTION*

GARY W. CLOW, DOUGLAS L. WHITING, ROBERT W. JOHNSON, ARTHUR J. COLLMEYER, JOHN R. WITZEL, ROBERT A. HOFF, CROSSPOINT VENTURE PARTNERS, LAWRENCE G. FINCH, SIGMA MANAGEMENT, SIGMA MANAGEMENT II, L.P., SIGMA PARTNERS, RUSSELL J. ROBELEN, IDANTA PARTNERS, STAC ELECTRONICS, ALEX. BROWN & SONS, INC. and MONTGOMERY SECURITIES, Defendants.	SECOND AMENDED CONSOLIDATED CLASS ACTION COMPLAINT FOR VIOLATION OF THE FEDERAL SECURITIES LAW
In re STAC ELECTRONICS SECURITIES LITIGATION	
This Document Relates To: ALL ACTIONS.	*Plaintiffs Demand A Trial By Jury*

Plaintiffs, by their undersigned attorneys, for their Complaint against defendants, allege upon information and belief except ¶¶20-21 which are alleged upon personal knowledge, as follows:

NATURE OF THE ACTION

1. This is a class action on behalf of all purchasers of the stock of Stac Electronics ("Stac" or the "Company") between May 7, 1992 and July 20, 1992. Stac manufactures data compression products that increase the effective

capacity of storage devices and are used by owners of personal computers that use Microsoft Corporation's MS-DOS or comparable operating systems. Stac's "Stacker" software products provide an increase in the data storage capacity of personal computers for much less cost than purchasing additional "hard disk" storage capacity. By 1990, millions of personal computers using the MS-DOS or comparable operating systems existed and appeared to provide a large potential market for Stac's Stacker products. Because Stac was first to market with a data compression software product, during 1991, sales of Stac's Stacker products exploded as users of personal computers found those products an inexpensive and effective way to increase the data storage capacity of the MS-DOS operating systems of their computers. This allowed Stac to achieve significant growth in its net income, as well as earnings per share through December 31, 1991.

2. By late 1991, 90% of Stac's revenues and over 90% of its profits came from the sale of its Stacker 2.0 data compression product. Because the then currently available versions of Microsoft's MS-DOS operating system did not have data compression capability, the sale of Stacker 2.0 to owners of personal computers using the MS-DOS operating system and purchasers of new computers which came with the MS-DOS operating systems was the main market for Stac's Stacker 2.0 product. However, Stac's business would be severely injured if Microsoft included data compression capability in its MS-DOS operating system (which Microsoft periodically updated), as computer owners using the MS-DOS system could then obtain data compression capability at no extra cost by obtaining the upgraded MS-DOS operating system

and purchasers of new personal computers supplied with the MS-DOS operating system would obtain that capability with the purchase of their computer and have no need to purchase separate software providing such capability.

3. As a result of the niche Stac had found in the personal computer software market, its revenue and net income exploded in the latter part of calendar 1991 and early 1992. However, Stac's top executives knew by late 1991 that Stac's competitive position was being impaired and that its strong growth in revenues and earnings would shortly come to an end because of the increased availability and popularity of competitive compression data products and because (as they had learned) Microsoft intended to include data compression capabilities in its next version of its MS-DOS operating system, which it was then currently developing and intended to release as soon as possible in 1992, and that this data compression capability would be included at no additional cost in Microsoft's upgraded MS-DOS system. This presented a terrible threat to Stac and its insiders. Thus, they decided to undertake a public offering of stock of the corporation, part of which was to be sold by the corporation and part of which was to be sold by insider and controlling stockholders in an effort to raise capital for the corporation to help it service the upcoming downturn in its business and allow the insiders to cash out of their illiquid Stac stock before these adverse facts became public knowledge, which they knew would destroy the value of their stock before they were able to complete a public offering.

4. However, by late 1991 and continuing up to the date of Stac's initial public offering on May 7, 1992 (the

"Offering"), the market and demand for Stac's products changed and Stac's insiders and controlling shareholders realized that Stac's profitable growth had peaked and that Stac would soon suffer declining revenues, net income and earnings per share. By the date of the public offering, Stac's insiders knew, but the public did not, that two very adverse facts existed that were negatively affecting Stac's business. First, demand for Stac's most important data compression product (Stacker 2.0) had weakened due to the introduction of a new popular competitive product and due to customer resistance to purchasing separate data compression software products in anticipation of the availability of upgraded personal computer operating systems that included data compression capacity. Stac's insiders and controlling shareholders knew, but the public did not, that this situation would worsen as Stac's data compression algorithm was not truly proprietary; nor was it adequately protected by patents, meaning other companies could quickly and cheaply create competitive products. Second, Stac's insiders and controlling shareholders knew, but the public did not, that Microsoft Corporation, the software giant on whose MS-DOS operating system Stac compression data products were dependent, had decided to include data compression capabilities in its next upgraded version of its MS-DOS operating system, which Microsoft was then developing and which it intended to announce and introduce as soon as possible in 1992. Stac's insiders and controlling shareholders knew these adverse facts meant that the results of operations of Stac's business had peaked and were beginning to decline and that Stac would not be able to continue to achieve the kind of

revenue and income gains in the future that it had enjoyed in the recent past.

5. Upon learning of Microsoft's decision to include compression data capability in its next upgraded MS-DOS operating system software, Stac's insiders knew that any announcement of Microsoft's decision would make the public offering they were contemplating impossible to achieve. Therefore, to delay such an announcement by Microsoft and to permit them to complete the public offering before this adverse information became public, Stac's insiders commenced a negotiation with Microsoft for Stac to license to Microsoft Stac's data compression technology, so that Microsoft could utilize that technology to create the data compression capability in its improved MS-DOS operating system. Although Stac realized that to license its technology to Microsoft for such purposes would also have a negative impact on its revenue growth and future profitability, as it would reduce the market for Stac's data compression products, it nevertheless pursued these negotiations because it never intended to reach an agreement with Microsoft; but rather, only to tie Microsoft up in negotiations for a long enough time to permit Stac to pull off its public offering prior to Microsoft announcing its decision to include data compression capability in its next upgrade of its MS-DOS operating system. Thus, during late 1991 through April-May 1992, Stac's top officers engaged in negotiations with Microsoft, during which negotiations Microsoft repeatedly confirmed to them that it was actively negotiating with other data compression software vendors to purchase or license their technology while also working on creating its own data compression capability and that

regardless of how the negotiations with Stac turned out, Microsoft had made the decision to include data compression capability in its next upgraded version of its MS-DOS operating system, which would be released as soon as possible in 1992.

6. In addition to attempting to delay any announcement of Microsoft's decision to include data compression capability in its upgraded MS-DOS operating system, Stac's insiders also undertook action to artificially inflate Stac's reported results for the last period (ending March 31, 1992) that would appear in the Prospectus, so as to make it appear that Stac was continuing to enjoy strong demand for its data compression products and achieving strong growth in revenues and profits, thus concealing that demand for its most important product had, in fact, weakened. This was achieved by Stac offering certain of its customers special terms beyond those it normally extended to induce them to order extra amounts of Stac's data compression products prior to March 31, 1992, including special price discounts and unlimited and/or expanded rights of return if the products were not resold. These activities were not the normal "channel fill" which customarily follows the introduction of a new product, but rather, extraordinary and unusual efforts to boost the sales of a product, demand for which was softening. By so doing, Stac improperly recorded revenues and understated its required reserves thus materially overstating its net income and earnings per share for the period ended March 31, 1992. Because Stac had by these actions "borrowed" large amounts of sales from future periods, Stac's insiders knew this virtually guaranteed that Stac's financial results following March 31, 1992, would decline

sharply from those reported for the March 31, 1992 period and in fact, by the time of the public offering Stac sales were already softening, in part because customers were already returning product purchased on special incentive terms prior to March 31, 1992, or refusing to order additional products, as they did not need any. In addition, by so doing, Stac's insiders exposed the corporation to substantial liability under its secret and undisclosed price protection obligation to its distributors, further insuring that Stac's future financial results would decline sharply after March 31, 1992.

7. Realizing that these negative trends were already adversely affecting, and would soon overwhelm, Stac's business, Stac's insiders and controlling shareholders decided to undertake a large public offering of Stac stock so that the Company and its controlling shareholders could obtain millions of dollars by selling Stac stock to public investors before the adverse conditions overtaking Stac's business could no longer be concealed and would become publicly known, which would make any such stock sale impossible. In order to achieve their goal, defendants issued a series of false and misleading statements in Stac's Prospectus for the Offering and on the multi-city "Road Show" undertaken to help sell the stock in that Offering, as well as in securities analysts' reports, press releases and other public statements issued there after to support and inflate the stock in the aftermarket. In these statements, defendants presented Stac's business in a very favorable light, without making any disclosure that, in fact, its business had peaked and was entering a period of adversity which would be characterized by

declining revenues and falling profits due to the adverse factors affecting its business that are detailed herein.

8. During the Road Show presentations, Stac and its underwriters stated the Company was enjoying strong demand for its Stacker 2.0 product and that Stac expected to achieve increased revenues in net income in the quarters following its March 31, 1992 quarter, forecasting earnings per share of $.55 and $.82 in fiscal 1992 and 1993, respectively.

9. The May 7, 1992 Prospectus presented Stac as a company that had recently reached profitability and was enjoying great success and strong growth – reporting the following:

Statement of Operations Data

	Fiscal Year Ended September 30,					Six Months Ended March 31,	
	1987	1988	1989	1990	1991	1991	1992
Revenues	$625	$749	$755	$1,762	$8,390	$2,333	$17,057
Operating income (loss)	47	(112)	(502)	(1,055)	133	(1,0333) [sic]	8,084
Net income (loss)	33	(58)	(477)	(948)	195	(983)	5,074
Net income (loss) per share	–	(.01)	(.03)	(.05)	.01	(.04)	.21

The Prospectus represented that Stac's *"revenues increased in each of the last six quarters,"* that *"the quarterly increases in revenues have been due primarily to increased demand for Stacker products . . . "* and that the *"increases in revenues in the second quarter of fiscal 1992 resulted partially from awards and reviews published in the quarter."* The Prospectus gave no indication that defendants knew that such growth would not continue, that Stac's orders had already begun to weaken by the date of the public offering and that Stac's profitability would decline sharply in coming months, stating only that Stac's net income would *"fluctuate"*[1] in the future.

10. Stac's May 7, 1992 Prospectus stated the Company's LZS technology used *"proprietary algorithms,"* its data compression products were *"for personal computers that use Microsoft Corporation's MS-DOS or compatible operating systems."* The Prospectus represented that Stac's *"discounting activities have [not] significantly affected revenues or results of operations in any given period," "price competition has not been a major factor for the Company's products,"* and that the *"Company believes that it provides adequate allowances for returns."* Finally, the Prospectus represented that the purpose of the stock offering was *"to increase the Company's equity capital,"* and to provide funds to *"increase," i.e.,* for *"expansion of [its] sales, marketing and support organization,"* as well as *"facilities expansion."*

11. The Prospectus contained a listing of certain "risks" of purchasing Stac stock, including that vendors

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[1] Here, as elsewhere, emphasis has been added unless otherwise noted.

of personal computer operating systems *"could* seek to expand their product offerings by designing and selling products using data compression technology," that there was *"no assurance Microsoft . . . will not incorporate a competitive data compression technology in their products," "no assurance that the Company will sustain its recent rate of revenue growth,"* and that it anticipated quarterly *"fluctuations"*[2] in net income in the future.

12. Two underwriting firms co-managed Stac's May 7, 1992 stock Offering. As they had agreed with Stac and its insiders they would do, as soon as they could after the "quiet period" following the Offering had expired, these firms issued very positive research reports on Stac, which strongly recommended purchase of the stock, while forecasting strong earnings growth in fiscal 1992, 1993 and 1994 to $.55, $.82 and $1.15 per share, respectively. These analysts' reports were based on information provided by Stac and its top officers, which reviewed and approved the reports, thus adopting them as their own. In addition to forecasting increasing earnings for Stac through fiscal 1994, the analysts' reports stated that Stac was *"the leading developer of data compression software for personal computers,"* was the *"best-poised company to exploit the data compression market's opportunities,"* and was *"well-positioned to take advantage of this market opportunity."* The analysts' reports also stated Stac had the *"dominant position in the underpenetrated and rapidly growing market for data compression products,"* that would *"enable it to emerge*

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[2] *Webster's New World Dictionary* defines "fluctuate" as "to vary irregularly" or "to rise and fall like waves; undulate."

as one of the leading players in the computer software industry" and *"the critical resources . . . necessary to sustain its recent success,"* even if additional competitors entered its markets.

13. In early July 1992, when another personal computer software company announced disappointing financial results and its and other software company stocks (including Stac's stock) declined, Stac's top executives and representatives of its underwriters quickly reassured the markets there were *"no corporate developments"* at Stac to account for the decline, there were no problems with Stac's business, that its Stacker 2.0 product *"continues to fly off the shelves,"* and that while overall economic softness would result in Stac achieving less revenue growth than earlier forecast, this was not due to problems specific to Stac or its products, and was not due to any *"channel-stuffing"* activity prior to or during Stac's strong March 31, 1992 quarter – representing that the strong sales growth it achieved in that quarter was due to *"glowing press reviews"* of its Stacker 2.0 product.

14. These statements were all false and misleading when made. Stac's products were not adequately protected by patents or truly proprietary algorithms. At the time of the Offering, Stac's business had peaked and begun to decline which Stac's insiders knew would result in Stac suffering declining revenues and falling net income. At the time of the Offering, demand for Stac's main products was already weakening and Stac was encountering problems in selling those products, in part due to the introduction of a new and very successful competitive data compression product – thus Stac was no

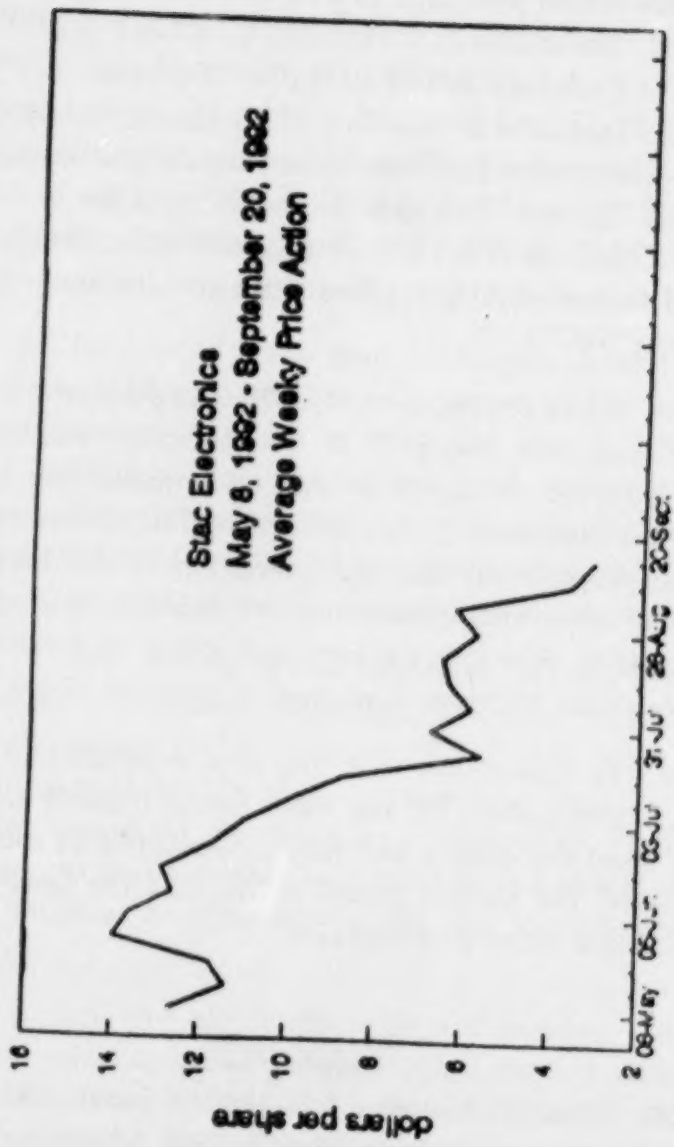
longer the leading company in the data compression software business. In addition, Stac knew that Microsoft had decided to introduce an enhanced version of its MS-DOS operating system which would for the first time include its own data compression capability ("DoubleSpace") which would greatly injure the market for Stac's main products. To conceal the softening demand for its products by March 31, 1992, Stac's insiders artificially inflated its sales and net income for that period by getting certain customers to take shipments of products by offering them special incentive terms, including price discounts and expanded rights of return, beyond those it extended in the ordinary course of business, thus "borrowing" sales from future periods and ensuring Stac's results from operations following the March 31, 1992 quarter would decline. Also, these artifices resulted in Stac's reserves for returns of product being inadequate. In addition, the Offering was not undertaken to increase Stac's equity capital or provide funds to expand Stac's business or increase its sales and marketing operations, but rather, to get cash to buffer the Company from the impending decline in its business and to enable Stac's insiders to cash out some of their Stac stock before its business collapsed.

15. As a result of these false and misleading statements and artifices, on May 7, 1992 Stac and certain of its insiders and controlling shareholders sold three million shares of Stac stock to the public at $12 per share in the Offering, obtaining $36 million, and thereafter pushed the stock price to a high of $15-3/4 per share in early June 1992, in part, by issuing securities analysts' reports which falsely presented the current condition of Stac's business,

Stac's competitive position and presented widely exaggerated forecasts of increased profitability in fiscal 1992, 1993 and 1994. But, on July 20, 1992, less than three months after the Offering, Stac revealed that its sales for its third quarter ended June 30, 1992 – *the quarter in which the public offering took place* – had *fallen* by almost 20% from the March 31, 1992 quarter, and that its net income had *fallen* by 34% – and that Stac expected its revenues and net income to *continue to decline*, due to falling sales of its Stacker 2.0 data compression product. In fact, Stac's business has consistently declined since the public offering and Stac has never again achieved net income or earnings per share that matched those reported for the quarter ended March 31, 1992. By 1993, Stac was reporting large losses, the firing of 20% of its employees and a shrinkage of its business. The chart below shows the collapse of Stac's business after the May 7, 1992 public offering:

	Quarter Ended (All amounts in thousands, except EPS)							
	12/31/91	3/31/92	6/30/92	9/30/92	12/31/92	3/31/93	6/30/93	9/30/93
Revenue	$5,393	$11,664	$10,000	$ 6,200	$12,300	$11,000	$ 5,700	$ 7,700
Net Income	857	4,200	2,700	526	2,100	1,000	(2,300)	(420)
Earnings Per Share	N/A	.17	.11	.02	.08	.04	(.10)	(.02)

16. Stac stock – sold to the public at $12 per share in May 1992 – collapsed to $5 per share in late July 1992 and declined to just $3 per share shortly thereafter, and ultimately to a low of $1-3/4 per share. The chart below shows the price action of Stac stock from May 7, 1992-September 20, 1992:


Stac Electronics
May 8, 1992 - September 20, 1992
Average Weeky Price Action
dollars per share
16
14
12
10
8
6
4
2

JURISDICTION AND VENUE

17. This court has jurisdiction over the subject matter of this action pursuant to § 22 of the Securities Act of 1933 (the "Securities Act") [15 U.S.C. § 77v], § 27 of the Securities Exchange Act of 1934 (the "Exchange Act") [15 U.S.C. § 78aa], and 28 U.S.C. § 1331. The claims asserted herein arise under §§ 11 and 15 of the Securities Act [15 U.S.C. §§ 77k and 77o], §§ 10(b) and 20(a) of the Exchange Act [15 U.S.C. §§ 78j(b) and 78t(a)], and Rule 10b-5 promulgated thereunder by the Securities and Exchange Commission ("SEC").

18. Venue is proper in this District pursuant to § 22 of the Securities Act, § 27 of the Exchange Act and 28 U.S.C. § 1391(b). Many of the acts and transactions giving rise to the violations of law complained of herein, including the preparation and dissemination to the investing public of false and misleading information, occurred in this District. Stac has its principal place of business at 5993 Avenida Encinas, Carlsbad, California 92008.

19. In connection with the acts, conduct and other wrongs complained of, the defendants, directly or indirectly, used the means and instrumentalities of interstate commerce, the United States mails, and the facilities of the national securities market.

THE PARTIES

20. Plaintiff Timothy J. Anderson purchased shares of Stac common stock on May 7, 1992 which stock was issued and distributed pursuant to the Registration Statement and Prospectus.

21. Plaintiffs Neil Singer and Arthur Singer each purchased 400 shares of Stac common stock on July 15, 1992 at $9.75 per share which stock was issued and distributed pursuant to the Registration Statement and Prospectus.

22. Defendant Stac Electronics designs, develops and markets data compression software. Data compression technology increases the data storage capacity of computers. The Company's products are sold directly to end users and through retail and distribution channels.

23. (a) At all times material hereto, defendant Gary W. Clow ("Clow") has been Chairman of the Board and Chief Executive Officer of Stac. On May 7, 1992, Clow sold 200,000 shares of common stock to the public by means of the false and misleading Registration Statement and Prospectus for $12.00 per share, realizing $2.4 million. Clow signed the Stac Registration Statement.

(b) At all times material hereto, defendant Douglas L. Whiting ("Whiting") has been Vice President of Technology and a director of Stac. On May 7, 1992, Whiting sold 200,000 shares of common stock to the public by means of the false and misleading Registration Statement and Prospectus for $12.00 per share, realizing $2.4 million. Whiting signed the Stac Registration Statement.

(c) At all times material hereto, defendant Robert W. Johnson ("Johnson") has been a director of Stac. On May 7, 1992, Johnson sold 100,000 shares of common stock to the public by means of the false and misleading Registration Statement and Prospectus for $12.00 per share, realizing $1.2 million. Johnson owned

2.2 million shares of Stac stock – 10.2% of its stock at the time of the Offering. Johnson signed the Stac Registration Statement.

(d) At all times material hereto, defendant Arthur J. Collmeyer ("Collmeyer") has been a director of Stac. On May 7, 1992, Collmeyer sold 8,000 shares of common stock to the public by means of the false and misleading Registration Statement and Prospectus for $12.00 per share, realizing $96,000. Collmeyer signed the Stac Registration Statement and was a member of Stac's Audit Committee.

(e) At all times material hereto, defendant John R. Witzel ("Witzel") has been Vice President of Finance and Operations and Chief Financial Officer of Stac. He signed the Registration Statement. Witzel sold 30,000 shares of common stock to the public by means of the false and misleading Registration Statement and Prospectus for $12 per share, realizing $360,000.

(f) Defendants Lawrence G. Finch ("Finch"), Robert A. Hoff ("Hoff"), and Russell J. Robelen ("Robelen") were each directors of Stac at all relevant times and each of them signed the Registration Statement. Hoff and Johnson were also members of Stac's Audit Committee.

(g) Defendant Finch has been a general partner of defendant Sigma Management, a California limited partnership, and Sigma Management II, L.P., the general partners of several venture capital funds, including Sigma Partners, a shareholder of the Company since 1989, and he served as its agent and representative on Stac's Board, regularly reporting to it as to his activities in that

regard and his knowledge gained in that capacity. This venture capital firm owned 3,250,000 shares of Stac stock at the time of the public offering – 14.8% of Stac's stock – and was a controlling shareholder and person of Stac and Finch.

(h) Defendant Hoff has been a general partner of defendant Crosspoint Venture Partners, a private venture capital firm, since 1983, and he served as its agent and representative on Stac's Board, regularly reporting to it as to his activities in that regard and his knowledge gained in that capacity. This venture capital firm owned 4,500,000 shares of Stac stock at the time of the public offering, 20.4% of Stac's stock, and was a controlling shareholder and person of Stac and Hoff.

(i) Defendant Robelen has been a general partner of defendant Idanta Partners since 1983, and he served as its agent and representative on Stac's Board, regularly reporting to it as to his activities in that regard and his knowledge gained in that capacity. This venture capital firm owned 2,475,000 shares of Stac stock at the time of the public offering, 11.2% of Stac's stock, and was a controlling shareholder and person of Stac and Robelen.

(j) Defendants Sigma Management, Sigma Management II, L.P., Sigma Partners, Crosspoint Venture Partners and Idanta Partners are named defendants in their capacity as controlling shareholders of Stac and their representatives on Stac's Board of Directors and as principals who each had agents who sat as their representatives on the Stac Board. They are collectively referred to herein as the "Venture Capital Firm defendants."

(k) By reason of their positions, the officer and/or director defendants identified in ¶23(a)-(i) (collectively the "Individual Defendants") had access to adverse material non-public information about Stac and were able to control directly or indirectly the acts of Stac and the contents of the statements disseminated during the Class Period by or in the name of Stac.

24. At all times material hereto, each of the Individual Defendants was the agent of each of the other Individual Defendants and of Stac, and was at all times acting within the course and scope of said agency. The Individual Defendants all held the positions indicated during the Class Period.

25. The Individual Defendants all participated in the drafting and preparation of the Prospectus and Registration Statement and the various public and other communications complained of herein and were aware of or recklessly disregarded the misstatements contained therein and omissions therefrom, and were aware of their materially misleading nature. Because of their Board membership and/or executive and managerial positions with Stac, each of the Individual Defendants had access to the adverse, non-public information about Stac's business prospects and financial condition as particularized herein. Each of the Individual Defendants, by reason of his stock ownership, management position, and/or membership on Stac's Board of Directors, was a controlling person of Stac and had the power and influence, and exercised the same, to cause Stac to engage in the illegal practices complained of herein.

26. In addition, the Individual Defendants, except Witzel, by reason of their stock ownership and their status as officers and/or directors of Stac were "controlling persons" within the meaning of § 15 of the Securities Act and § 20 of the Exchange Act. Because of their positions of control, these defendants were able to and did directly or indirectly, control the conduct of Stac's business, the information contained in the filings with the SEC and public statements about its business.

27. The Individual Defendants, because of their positions of control and authority as officers and/or directors of the Company were able to and did control the contents of the Prospectus and Registration Statement, press releases, and presentations to securities analysts pertaining to the Company. Each Individual Defendant was provided with copies of Stac's press releases and SEC filings alleged herein to be misleading prior to or shortly after their issuance and had the ability and opportunity to prevent their issuance or to cause them to be corrected. Because of their Board membership and/or executive and managerial positions with Stac, each Individual Defendant had access to the adverse, non-public information about Stac's business particularized herein, *via* access to internal corporate documents, conversations or connections with the corporate officers, employees, attendance at Stac's management and Board of Directors meetings and committees thereof and *via* reports and other information provided to them in connection therewith. As a result, each of these defendants was responsible for the accuracy of the public reports and releases detailed herein as "group published" information and is therefore

responsible and liable for the representations contained therein.

28. (a) Defendant Alex. Brown & Sons, Inc. ("Alex. Brown") is a broker/dealer and securities underwriting firm headquartered in Baltimore, Maryland. Pursuant to an Underwriting Agreement, Alex. Brown acted as one of the Co-lead Underwriters with respect to the sale of the common stock of Stac pursuant to the Registration Statement and Prospectus. Alex. Brown received substantial fees in connection with the Offering of the common stock of Stac.

(b) Defendant Montgomery Securities ("Montgomery") is a broker/dealer and securities underwriting firm headquartered in San Francisco, California. Pursuant to an Underwriting Agreement, Montgomery acted as one of the Co-lead Underwriters with respect to the sale of Stac common stock pursuant to the Registration Statement and Prospectus. Montgomery received substantial fees in connection with the Offering of the common stock of Stac.

(c) During the Class Period Alex. Brown and Montgomery acted as agents for Stac, and helped to support (inflate) the price of Stac stock in the aftermarket by creating – with Stac's help – and issuing false and misleading securities analysts' reports on Stac.

(d) As part of the Offering, Alex. Brown and Montgomery (collectively the "Underwriter Defendants") conducted or participated in an investigation, known as a "due diligence" investigation, into the business, operations, and prospects of Stac, as well as the Company's financial condition, accounting and management control

systems. In the course of such investigation, Alex. Brown and Montgomery either obtained knowledge of, or recklessly disregarded or failed to perform reasonable due diligence sufficient to discover the facts set forth herein. Alex. Brown and Montgomery were agents of the Company through which Stac common stock was sold in the Offering. In order to help sell the Offering, the underwriters arranged and conducted a "Road Show" a few weeks before the May 7, 1992 public offering, during which they and Stac's top officers visited several U.S. cities (including New York, Chicago and San Francisco) and met with institutional investors, securities analysts and others to present favorable information about Stac to create demand for its stock to be sold on the Offering. In addition, the Underwriter Defendants acted as market-makers for Stac common stock and issued research reports to the investment community which described the financial and business prospects of Stac. In these various capacities, defendants Alex. Brown and Montgomery had access to material non-public information about Stac's business, finances, products and future business prospects. The Underwriter Defendants violated the federal securities laws, as alleged herein, in part, to obtain their share of the $2.5 million in fees the underwriters received from the proceeds of the Offering.

DUTIES OF STAC'S OFFICERS AND DIRECTORS

29. Stac and each officer and director of Stac owed to its shareholders and the investing public in general the duty to exercise due care and diligence in the management and administration of the affairs of Stac, as well as the duty of full and candid disclosure of all material facts

related thereto. In addition, under federal and state law, these defendants owed prospective purchasers of Stac common stock the duty to exercise care that public statements regarding the Company, its business, its management, its products, its internal controls and management information systems, its markets and present and future business prospects would be complete, accurate and truthful and not in any way materially misleading. To discharge their duties, the Individual Defendants were required to exercise reasonable and prudent supervision over the management, policies, practices and financial controls of Stac. By virtue of such duties, these officers and directors of Stac were required, *inter alia*:

(a) To manage, conduct, supervise and direct the business and affairs of Stac in accordance with the laws of the State of California, federal law, state and federal rules and regulations and the Articles and By-laws of Stac;

(b) To neither violate nor knowingly or recklessly permit any officer, director or employee of Stac to violate applicable federal laws, rules and regulations, including federal and state securities laws;

(c) To establish and maintain systematic and accurate books and records of the business and affairs of Stac and procedures for reporting Stac's business and affairs to Stac's Board of Directors and to periodically investigate, or cause independent investigation to be made, of said books and records;

(d) To maintain and implement an adequate and functioning system of internal financial, accounting

and inventory controls and management information systems, such that Stac's financial statements and information would be accurately recorded and reported and corporate managers would be given prompt notice of serious problems so that such problems could be adequately addressed, resolved and disclosed and so that risk to Stac and its investors would be minimized;

(e) To supervise and review the preparation and filing of any audits, reports, or other information required by law from Stac, including the Company's Prospectus and Registration Statement, Forms 10-K, 10-Q, and proxy statements and to examine, evaluate and approve any reports of examination, audits or other financial "group published" information concerning the financial affairs and condition of Stac and to make full and accurate disclosure of all material facts concerning, *inter alia*, each of the subjects set forth above;

(f) To refrain from either obtaining personal benefit at the expense of the public security holders of Stac, or misusing proprietary non-public corporate information; and

(g) Under rules and regulations promulgated by the SEC under the Exchange Act, specifically Item 303 of Regulation S-K, the Individual Defendants also had a duty to report all known trends, events or uncertainties that were reasonably likely to: (i) impact Stac's liquidity; (ii) impact Stac's net sales, revenue and/or income; and/or (iii) cause previously reported financial information to not be necessarily indicative of future operating results.

The Individual Defendants' representations and non-disclosures during the Class Period violated these specific requirements and obligations.

30. During the Class Period, each of the Individual Defendants occupied positions with Stac or were associated with the Company in such a manner as to make them privy to confidential proprietary information concerning Stac, its operations, finances, financial condition, products and present and future business prospects. Because of these positions and such access, each of these defendants knew or recklessly disregarded that the adverse facts specified herein had not been disclosed and were being concealed from the public.

31. Notwithstanding their duty to refrain from selling Stac common stock while in the possession of material, adverse, non-public information concerning Stac, each of the Individual Defendants sold shares of the Company's common stock during the Class Period.

FRAUD-ON-THE-MARKET DOCTRINE

32. The market price for Stac stock is reflective of an efficient market for the following reasons, among others:

(a) Stac met the requirements for listing, and was listed on the NASDAQ National Market System, a highly efficient and automated market;

(b) Stac files periodic public reports with the SEC and NASDAQ;

(c) Stac's trading volume was substantial, averaging 150,000 shares a day during the Class Period thereby reflecting numerous trades each day; and

(d) Stac was followed by analysts employed by brokerage firms who wrote reports which were distributed to the sales force and certain customers of their respective brokerage firms and which were available publicly through various automated data retrieval services.

PLAINTIFFS' CLASS ALLEGATIONS

33. Plaintiffs bring this action as a class action pursuant to Federal Rules of Civil Procedure 23(a) and (b)(3) on behalf of all persons who purchased the common stock of Stac from May 7, 1992 through July 20, 1992 (the "Class Period"). Excluded from the Class are the defendants herein, members of the immediate family of each of the Individual Defendants, any entity in which any defendant has a controlling interest, and the legal representatives, heirs, successors or assigns of any such excluded party.

34. (a) Members of the Class are so numerous that joinder of all members is impracticable. While the exact number of Class members is unknown to plaintiffs at the present time, Stac issued 3 million shares of common stock pursuant to the Offering and which were acquired by hundreds or thousands of shareholders throughout the country.

(b) Plaintiffs' claims are typical of the claims of the Class because plaintiffs and all the Class members sustained damages which arose out of the defendants' wrongful conduct complained of herein.

(c) Plaintiffs are representative parties who will fully and adequately protect the interests of the Class members. Plaintiffs have retained counsel who are experienced and competent in both class action and securities litigation. Plaintiffs have no interest which is contrary to or in conflict with those of the Class they seek to represent.

(d) A class action would be superior to all other available methods for the fair and efficient adjudication of this controversy. Plaintiffs know of no difficulty to be encountered in the management of this action that would preclude its maintenance as a class action.

(e) The prosecution of separate actions by individual Class members would create a risk of inconsistent and varying adjudications concerning the subject of this action, which adjudications could establish incompatible standards of conduct for defendants under the laws alleged herein. Further, questions of law and fact common to the members of the Class predominate over any questions which may affect only individual members in that defendants have acted on grounds generally applicable to the entire Class. Among the questions of law and fact common to the Class are:

(i) Whether the federal securities laws were violated by defendants' acts as alleged herein;

(ii) Whether Stac's publicly disseminated statements during the Class Period misrepresented and/or omitted material facts;

(iii) Whether defendants participated in and pursued the common course of conduct complained of herein;

(iv) Whether defendants are strictly liable for the misrepresentations in the Prospectus;

(v) Whether defendants acted willfully or recklessly in misrepresenting and/or omitting material facts or in aiding and abetting the making of such misstatements;

(vi) Whether the market prices of Stac common stock during the Class Period were artificially inflated due to the misrepresentations and/or nondisclosure complained of herein; and

(vii) The extent of losses sustained by members of the Class and the appropriate measure of damages.

SUBSTANTIVE ALLEGATIONS

35. By 1990, millions of personal computers using the MS-DOS or comparable operating systems existed and appeared to provide a large potential market for Stac's Stacker products. Because Stac was first to market with a data compression product, during 1991, sales of Stac's Stacker products exploded as users of personal computers found Stac's data compression products an inexpensive and effective way to increase the data storage capacity of the MS-DOS operating systems of their computers. This led to Stac achieving significant growth in its revenues, and net income, as well as earnings per share through December 31, 1991.

36. By late 1991, 90% of Stac's revenues and over 90% of its profits came from the sale of its Stacker 2.0 data compression product. Because the then currently available versions of Microsoft's MS-DOS operating system did not have data compression capability, the sale of Stacker 2.0 to owners of personal computers using the MS-DOS operating system and purchasers of new computers which came with the MS-DOS operating systems was the main market for Stac's Stacker 2.0 product. However, Stac's business would be severely injured if not destroyed if Microsoft included data compression capability in its MS-DOS operating system (which Microsoft periodically updated), as computer owners using the MS-DOS system could then obtain data compression capability at no extra cost merely by obtaining the upgraded MS-DOS operating system and purchasers of new personal computers supplied with the MS-DOS operating system would obtain that capability upon purchase of their computer and have no need to purchase separate software providing such capability.

37. As a result of the niche in the personal computer software market Stac was exploiting, its revenue and net income exploded in the latter part of calendar 1991 and early 1992. However, Stac's top executives knew by late 1991 or early 1992 that Stac's competitive position was being impaired and that its strong growth in revenues and earnings would shortly come to an end because of softening demand for its Stacker 2.0 product, the increased availability of effective and low priced competitive compression data products and because they had

learned that Microsoft intended to include data compression capabilities in its next version of its MS-DOS operating system, which it was then currently developing and intended to commence and release as soon as possible in 1992, and that this data compression capability would be included at no additional cost in Microsoft's upgraded MS-DOS system.

38. This situation posed a serious threat to Stac, its insiders and controlling shareholders. Because their stockholdings in Stac were illiquid and they had no way to sell their stock to lessen the adverse impact the coming decline in Stac's business would have on their holdings, Stac's insiders could not sell their Stac shares privately, as potential buyers in a private sale would be sophisticated and would know of or learn of Stac's deteriorating competitive position and its poor future prospects, during the pre-purchase due diligence investigation they would have to be permitted to undertake. Since they could not sell their Stac stock privately, the insiders pursued a public offering of Stac stock whereby the stock would be sold to public investors, thereby raising large amounts of money for Stac and its insiders. They also knew that once these adverse conditions began to manifest themselves publicly, it would be impossible to sell Stac stock in a public offering. Thus, Stac's insiders decided to undertake a public offering of stock of the corporation, part of which was to be issued by the corporation and part of which was to be sold by insider and controlling stockholders in an effort to raise capital for the corporation to cushion it against the impending decline of its business and allow the insiders to cash out of some of their illiquid Stac stock before these adverse facts became public

knowledge, which they knew would result in them not being able to complete a public offering of Stac stock.

39. Upon learning of Microsoft's decision to include compression data capability in its soon to be announced upgraded MS-DOS operating system software, Stac's insiders knew that any such disclosure would make the public offering they were contemplating impossible to achieve. Therefore, to delay such an announcement by Microsoft and to permit them to complete the public offering before this adverse information became public, Stac's insiders commenced a negotiation with Microsoft to license to Microsoft Stac's data compression technology, so that Microsoft could utilize that technology to create the data compression capability in its improved MS-DOS operating system. Although Stac realized that to license its technology to Microsoft for such purposes would also have a negative impact on its revenue growth and profitability, as it would diminish the market for its own data compression products, it nevertheless continued these negotiations because it never intended to reach any agreement with Microsoft; but rather, only to tie Microsoft up in negotiations for a long enough time to permit Stac to pull off its public offering before Microsoft announced its decision to include data compression capability in its next upgrade of the MS-DOS operating system. Thus, during late 1991 through the date of Stac's public offering, Stac's top officers engaged in continuous negotiations with Microsoft, during which negotiations they were repeatedly informed by Microsoft that Microsoft was actively working on creating its own data compression capability and that regardless of how the negotiations with Stac turned out, Microsoft had decided

to include data compression capability in its next upgraded version of its MS-DOS operating system, which would be released as soon as possible in 1992.

40. In addition to attempting to delay any announcement of Microsoft's decision to include data compression capability in its upgraded MS-DOS operating system, Stac's insiders also undertook action to artificially inflate Stac's reported results for the last period (ending March 31, 1992) that would appear in the Prospectus, so as to make it appear that Stac was continuing to enjoy strong demand for its data compression products and achieving strong growth in revenues and profits, thus concealing that demand for its most important product had, in fact, weakened. This was achieved by Stac offering certain of its customers special terms beyond those it normally extended to induce them to order extra amounts of Stac's data compression products prior to March 31, 1992, including special price discounts and unlimited and/or expanded rights of return if the products were not resold. These activities were not the normal "channel fill" which customarily follows the introduction of a new product, but rather, extraordinary and unusual efforts to boost the sales of a product, demand for which was softening. By so doing, Stac improperly recorded revenues and understated its required reserves and thus materially overstated its net income and earnings per share for the period ended March 31, 1992. Because Stac had by these actions "borrowed" large amounts of sales from future periods, Stac's insiders knew this virtually guaranteed that Stac's financial results following March 31, 1992, would decline sharply from those reported for the March 31, 1992 period and in fact, by the time of the

public offering Stac sales were already softening, in part because customers were already returning product purchased on special incentive terms prior to March 31, 1992, or refusing to order additional products, as they did not need any. In addition, by so doing, Stac's insiders exposed the corporation to substantial liability under its secret and undisclosed price protection obligation to its distributors, further insuring that Stac's future financial results would decline sharply after March 31, 1992.

41. Stac, its insiders and controlling shareholders thus retained Montgomery and Alex. Brown to help them and act as Stac's agents in the Offering and to help boost or support Stac's stock in the aftermarket. They obtained commitments that Montgomery and Alex. Brown would help them prepare a Prospectus which would present the Company in an attractive manner and assist in marketing the stock via a "Road Show" whereby Stac and its top officers (specifically, Clow and Witzel) would make highly favorable presentations to potential investors to help create strong demand for the stock. Stac and its insiders also secured commitments from Montgomery and Alex. Brown that after the Offering, analysts from those firms would issue favorable reports on Stac which would support Stac stock in the aftermarket, *i.e.*, *"booster shots."* For this the Underwriters would be paid over $2.5 million by Stac, its insiders and its controlling shareholders out of the Offering proceeds. The Offering was also extremely beneficial to Stac and the insiders, enabling them to obtain large amounts of cash which none of them could have otherwise obtained once the truth about Stac's business came out. In addition, because Stac's business was about to decline, the stock sale was

very beneficial to its insiders and controlling shareholders, as the cash received by Stac in the Offering would help insulate it and its insiders to a substantial degree from the adverse effects the coming decline would have on Stac's business, as it would give Stac cash to mitigate the impact of the decline. The cash infusion also pumped up Stac's book value by almost 300% to $1.02 per share from $.36 per share – an instant $14.5 million gain for Stac's insiders and controlling stockholders in the book value of their remaining 22 million shares of Stac stock.

42. By the time of the May 1992 Offering, Stac's business had actually begun to be adversely impacted by the negative factors its insiders and controlling shareholders knew were overtaking it. In order to conceal the negative impact of these factors and hide the adverse trends hurting Stac's business and its increasingly impaired competitive position, Stac and its insiders took steps to artificially inflate its revenues and net income as of March 31, 1992, and the defendants issued a materially false and misleading Prospectus. While the Prospectus contained some cautionary language (which was itself false and misleading), the defendants diluted that language by undertaking an extensive "Road Show" prior to the Offering, *i.e.*, presentations to prospective investors in several cities, stressing the continued strong demand for its products, its successful development and introduction of new products and its strong competitive position, while making bullish forecasts of continued profitable growth through fiscal 1992 and 1993, which presentations were much more positive than the information contained in the Prospectus. This positive information was also

distributed to securities houses which were members of the Stock Offering selling group and used by them to create "sales sheets" or "talking points" for presentations by their brokers to customers to help sell Stac's stock. This operated to create a false and misleading impression concerning Stac and created such demand for the Offering that Stac's stock was viewed as a "hot" offering, thus enabling Stac and its insiders to sell 3 million shares of stock at $12 per share.

43. The Road Show presentations took place in several U.S. cities, including New York, Chicago and San Francisco, in the three weeks prior to the May 7, 1992 stock sale. During the Road Show presentations, which included an extensive slide show and oral presentations by Stac executives Clow (CEO) and Witzel (CFO), the following information was provided to potential investors during the Road Show presentations:

(a) Stac's business was strong and demand for its data compression products was stable or increasing;

(b) Stac had achieved extremely strong revenue and earnings growth in the quarter ended March 31, 1992, in part due to favorable publicity for and awards received by its Stacker 2.0 product;

(c) Stac was forecasting continued strong revenue and net income growth in succeeding quarters such that its earnings per share would consistently increase during the balance of fiscal 1992 and total $.55 per share, increase in fiscal 1993 to $.82 per share and reach $1.15 per share in fiscal 1994. This same information was in the "sales sheets" and "talking points" distributed to brokers

who worked for members of the underwriting group to help sell the Stac stock.

44. The information presented on the Road Show and in the "sales sheets" and "talking Points" was false and misleading. The true facts, which were concealed, were:

(a) Demand for Stac's main compression data product had weakened and that in order to stimulate sales of those products, Stac was granting special incentive terms, including price discounts and rights of return beyond those it normally granted in the ordinary course of business;

(b) That in order to artificially increase the revenues and net income Stac reported for the quarter and the six months ended March 31, 1992, Stac induced certain of its customers to order extra merchandise on special terms, which it did not grant in the ordinary course of business, and which Stac knew could not be sold by them in the near term;

(c) That Stac had achieved strong revenue and net income growth in its second quarter of fiscal 1992 ended March 31, 1992, not because its data compression products had received favorable publicity in trade publications and awards but rather due to the special price discounts and sales terms referred to above;

(d) Because Stac had sold significant amounts of data compression products prior to March 31, 1992 on special terms, which included increased rights of return for unsold product, without setting up sufficient reserves

for later returns of product, Stac's revenues and net income for that period were materially overstated;

(e) Because demand for Stac's main product was weakening, because Stac had "borrowed" sales from future periods to artificially inflate its March 31, 1992 financial results, and because Microsoft would soon be announcing an enhanced version of its MS-DOS operating system that would include data compression capability at no extra cost, Stac's revenues, net income and earnings per share would fall substantially following the public offering; and

(f) There was no reasonable basis in fact for the forecasts of increased earnings per share in fiscal 1992-1994, for Stac, which forecasts were, in fact, contradicted by and inconsistent with information known only to defendants, due to their access to material non-public information about Stac's business.

45. On May 7, 1992, Stac, its insiders and its controlling shareholders sold three million shares of stock to the public at $12 per share. Of the three million shares, the Company sold 1,500,000 shares; selling stockholders, which included certain defendants as particularized at ¶23(a)-(e), sold 1,500,000 shares; all via a Registration Statement and Prospectus, effective with the SEC on that date.

46. The Prospectus described Stac as follows:

> Stac Electronics designs, develops, markets and supports data compression products that increase the effective capacity of storage devices and transmission rates of data communications systems. *The Company's Stacker LZS technology*

uses proprietary algorithms to compress and decompress data in an efficient, transparent operation that maintains complete data integrity. The Company has implemented its data compression technology in a variety of software and semiconductor-based products, including the *Stacker* family of software and add-in boards that provide convenient, cost-effective and reliable data compression. *Introduced in December 1990, the Company's Stacker products generally provide a two-fold increase in effective storage capacity for personal computers that use Microsoft Corporation's MS-DOS or compatible operating systems. Stacker products are fully compatible with Microsoft Windows as well as popular applications software. . . . The Company sells Stacker products through distributors in the United States and internationally and directly to end users.*

* * *

Stac Electronics designs, develops, markets and supports data compression products that increase the effective capacity of storage devices and transmission rates of data communications systems. The Company's Stacker LZS technology uses proprietary algorithms to compress and decompress data in an efficient, continuous, transparent operation that maintains data integrity. The Company has implemented its data compression technology in a variety of software and semiconductor-based products, including the *Stacker* family of software and add-in boards that provide convenient, cost-effective and reliable data compression. Introduced in December 1990, *Stacker products generally provide a two-fold increase in effective storage capacity for personal*

computers that use MS-DOS or compatible operating systems and are fully compatible with Microsoft Windows and popular applications software.

Background

The management, storage and communication of increasingly large amounts of data are key challenges currently confronting computer users and designers.

* * *

These trends have heightened the need for cost-effective solutions to the issues and problems currently associated with the management, communication and storage of ever increasing amounts of data.

Historically, there have been a number of approaches to address these problems: active management and maintenance of files to reduce demands on installed storage devices with higher capacity storage devices; . . . or purchase of new systems with higher capacity storage devices.

Active file management and maintenance is a low-cost approach to the problem of data storage. It is not an effective solution, however, when data files and applications programs permanently occupy large amounts of storage capacity. Moreover, active file management and maintenance does not address the need for faster, more efficient data communications.

The substitution of higher capacity storage devices enables users to increase system storage capacity without buying an entire new system. Hardware upgrades are relatively expensive, time-consuming and require computer down-

> time and file transfers while the upgrade is being put in service. Although new computer systems may offer greater storage capacities than older systems, they do not address the needs of users of installed computers who do not wish to incur the expense of an entire system upgrade.

47. The Prospectus presented Stac's financial performance, showing strongly increasing revenues and profits in recent months, without any disclosure that factors then existed that had caused that trend to end, would cause demand for Stac's products to weaken and would result in Stac's revenues, net income and earnings per share declining sharply immediately after its offering. The Prospectus reported:

	Fiscal Year Ended September 30,					Six Months Ended March 31,	
	1987	1988	1989	1990	1991	1991	1992
Revenues	$625	$749	$755	$1,762	$8,390	$2,333	$17,057
Net income (loss)	33	(58)	(477)	(948)	195	(983)	5,074
Net income (loss) per share	–	(.01)	(.03)	(.05)	.01	(.04)	.21

With respect to Stac's quarterly results, the Prospectus reported:

	Quarter Ended June 30,	September 30,	December 31,	March 31,
	1991	1991	1991	1992
Revenues	$2,991	$3,066	$5,393	$11,664
Net income	–	12	396	2,638
	$ 895	$ 283	$ 857	$ 4,217

48. The Prospectus explained these favorable financial results as follows:

> Revenues increased in each of the last six quarters. *The quarterly increases in revenues have been due primarily to increased demand for Stacker products, which the Company believes was the result of increased marketing and selling efforts* and the expansion of distribution channels during the second and third quarters of fiscal 1991 to include national distributors and resellers. The Company believes that revenues in the fourth quarter of fiscal 1991, which were slightly higher than in the preceding quarter, were negatively affected by anticipation in the distribution channel of the release of new versions of Stacker products in late September 1991. *The Company believes that the increase in revenues in the second quarter of fiscal 1992 resulted partially from awards and reviews published in that quarter.*
>
> The Company believes that substantially all of its Stacker revenues to date have resulted from sales to new customers as opposed to purchases of upgrades by existing customers. The Company sells substantially all of its products based on an established discount structure, which has not varied significantly from quarter to quarter. *The Company does not believe that its discounting activities have significantly affected revenues or results of operations in any given period.*

49. These statements were false and misleading. The true facts, which were concealed, were:

(a) Stac's March 31, 1992 financial statements overstated Stac's revenues, net income and earnings per share as detailed elsewhere in this complaint;

(b) The Company's LZS technology did not use proprietary algorithms and, in fact, key parts of such technology were in the public domain and could be utilized by others to quickly and cheaply create competitive products;

(c) That Stac had learned that Microsoft had decided to include (at no extra cost) data compression capability ("DoubleSpace") in its next version of its MS-DOS operating system which it intended to announce and introduce as soon as possible in 1992;

(d) That Stac was attempting to delay Microsoft's announcement that it had decided to include data compression capability in Microsoft's enhanced MS-DOS operating system to be introduced as soon as possible in 1992;

(e) Demand for Stac's main compression data product (Stacker 2.0) had weakened, due in part to the introduction of a new and successful competitive product, and that in order to stimulate sales of those products, Stac was granting special sales incentive terms, including price discounts and rights of return beyond those it normally granted in the ordinary course of business;

(f) That in order to inflate the revenues and net income Stac reported for the quarter and the six months ended March 31, 1992, Stac had induced certain of its customers to order extra merchandise on consignment terms, which it did not grant in the ordinary course of business, and which were not bona fide sales;

(g) That in order to stimulate sales of its products at the end of the quarter ended March 31, 1992, Stac

was granting special discount prices to selected customers which, combined with price cuts which Stac anticipated making publicly, would trigger substantial liability of Stac under the price protection agreements it had with its customers;

(h) That Stac had achieved strong revenue and net income growth in its second quarter of fiscal 1992 ended March 31, 1992, not because its Stacker 2.0 data compression product had received favorable publicity in trade publications and awards but rather, due to the special price discounts and sales terms referred to above;

(i) Because Stac had "borrowed" sales from future periods in order to artificially inflate sales of its data compression products prior to March 31, 1992, and because Stac knew Microsoft would soon be announcing an enhanced MS-DOS operating system which included data compression capability, Stack's revenues and net income were going to decline sharply;

(j) That because of the factors set forth above, Stac's business had peaked and was entering a period of protracted decline, whereby the Company's profits and earnings per share would decline to levels well below those achieved in the recent past;

(k) That Stac's business was entering an extremely difficult period characterized by increased competition and decreased selling prices for Stac's products, such that Stac would suffer a serious decline in its business;

(l) That Stac's main product line – data compression products – would soon be severely disadvantaged in the marketplace by Microsoft's announcement of an improved MS-DOS operating system that would include data compression capability at no additional costs, thus ending Stac's ability to achieve continued profitable growth; and

(m) That Stac's profits had peaked during the first quarter of calendar 1992 and because of the factors stated above, had entered a period of protracted decline.

50. With respect to marketing and sales, the Prospectus stated:

> *The Company's return policy allows its distributors to return any new, unused product in the distributor's inventory within a contractually defined period of 60 days from the notice of discontinuance of any product, or any version of a product, for a credit or cash refund.* In addition, distributors may participate quarterly in a stock balancing program which, subject to certain limitations, allows them to return purchased products within the second month of each calendar quarter for full credit towards future purchases. The Company believes that this stock balancing provision is customary in the industry and should not materially increase risks associated with the relationship given its limited nature. End users may return defective products pursuant to policies established by their dealer. The Company will make a refund or exchange at cost through the dealer's distributor. *Although the Company believes that it provides adequate allowances for returns, there can be no assurance that actual returns in excess of recorded allowances will not*

result in a material adverse effect on the Company's business, operating results or financial condition.

51. These statements were false and misleading. The true facts, which were concealed, were:

(a) Because demand for Stac's main compression data products had weakened and in order to stimulate sales of those products, Stac was granting special sales incentive terms including rights of return beyond those it normally granted;

(b) Because Stac had sold significant amounts of data compression products prior to March 31, 1992 on special terms, granting increased rights of return for unsold product without increasing Stac's reserves for such returns, Stac knew that its existing reserve for returns was inadequate and that this would require Stac to take increased reserves as charges to earnings in the future as those special rights of return were exercised as Stac knew they would be, thus adversely affecting Stac's results from operation in the near future; and

(c) That in order to stimulate sales of its products, Stac was offering special discount prices to selected large customers which, when combined with price cuts which Stac was anticipating making publicly, would trigger substantial liability of Stac under its price protection agreements with its customers, thus adversely affecting Stac's results from operations in the near future.

52. With respect to Stac's competitive position, the Prospectus stated, in part:

The Company believes that the primary competitive factors in the personal computer

data compression product market *are product features and performance, product compatibility and reliability, ease of use, product reputation, price, timeliness of product upgrades and the quality of customer support and service. The Company believes that its Stacker products provide a combination of speed and data compression that is superior to the performance of competing products.* The Company believes that its Stacker products are easier to use and generally utilize less memory than competing products. Certain of the competing products compete favorably with the Company's Stacker products with respect to price and one competing product competes favorably with respect to compression speed in a software-only product offering. *Although to date price competition has not been a major factor for the Company's products, it may become a significant factor in the future.*

53. These statements were false and misleading. The true facts, which were concealed, were:

(a) Demand for Stac's main compression data products (Stacker 2.0) had weakened, in part due to the introduction of a new and successful competitive product;

(b) That Stac had learned that Microsoft had decided to include (at no extra cost) data compression capability ("DoubleSpace") in its next version of its MS-DOS operating system which it intended to announce soon and introduce as soon as possible in 1992;

(c) That in order to stimulate sales of its products at the end of the quarter ended March 31, 1992, Stac

was granting special discount prices to selected customers which, combined with price cuts which Stac anticipated making publicly, would trigger substantial liability of Stac under the price protection agreements it had with its customers;

(d) The market for Stac's data compression products was not as large or as promising as represented due to the growing success of competitive products and the fact that Microsoft had decided to include data compression capability in its next upgraded version of its MS-DOS operating system; and

(e) Stac's information confirmed that its main product line would, in essence, be obsoleted by Microsoft's introduction of its enhanced MS-DOS operating system, including data compression capability, making successful expansion and continued profitable growth for Stac impossible.

54. As to the purpose of the stock offering, the Prospectus stated:

> The principal purposes of this offering *are to increase the Company's equity capital, to create a public market for the Common Stock and to facilitate future access by the Company to public equity markets.*

In discussing the use of proceeds of the public offering, the Prospectus stated:

> Use of proceeds. . . . .Working capital, product development, *expansion of sales, marketing and support organizations, facilities expansion* and

other general corporate purposes.

* * *

The Company expects to use the net proceeds of this offering for working capital; to fund product development; *to increase the Company's sales, marketing and customer support organizations; for expansion of facilities;* and for general corporate purposes.

This language indicated that Stac was selling stock to raise monies to continue the expansion of its business and that investors' monies were going to be used by Stac to *expand* a successful business and *increase* its sales and marketing operations.

55. These statements were false and misleading because they failed to disclose:

(a) The primary purpose of the Offering was not "to create a public market for the Company's Common Stock," but rather to raise capital for Stac that it would not be able to raise via a stock sale when the adverse impact of its undisclosed problems as detailed above became apparent to the public;

(b) A principal purpose of the Offering was not to increase the Company's equity capital but to enable certain insiders and controlling stockholders to sell their Stac stock before the public learned the truth about the adverse conditions plaguing Stac's business; and

(c) Stac had no real need for additional working capital and had no expectation of significantly expanding any part of its business, but was selling stock to raise cash to buffer itself against the decline in its business it

knew was coming and which would make a later stock sale impossible.

56. The Prospectus contained a list of "Risk Factors," which created the illusion of candor, while actually containing misleading information. These purported "risk" disclosures were themselves false and misleading as they gave the impression that the risks which faced Stac were nothing more than that, *i.e.*, just risks of things that *"may"* or *"could"* occur. In fact, however, several of the conditions presented merely as abstract risks were, at the time of the Offering, realities, already adversely affecting Stac's business, as at the time of the Offering its business and profitability had peaked and would soon decline, thus meaning that Stac would suffer declining revenue and sharply declining profits in the near future.

57. Thus, despite its "risk factors" the Prospectus failed to disclose that the Company's current sales and profit sharing were already being impaired by the success of a new competitive product and weakening demand for its Stac 2.0 product and that its future prospects had, in fact, already been impaired due to Microsoft's decision to include data compression capability in its enhanced version of its MS-DOS operating system which it intended to introduce as soon as possible in 1992 and which would sharply reduce the market for, and growth potential of, Stac's main product.

58. The Prospectus contained the following "Risk Factor" language concerning competition:

> *Competition*. The market for the Company's products is intensely competitive. A number of

competitors offer products that currently compete with one or more of the Company's products. Other companies in the personal computer industry, such as operating systems vendors, utility software vendors, microprocessor and chip set suppliers, disk drive manufacturers and personal computer manufacturers, *could* seek to expand their product offerings by designing and selling products using competitive data compression or other technology that could render obsolete or adversely affect sales of the Company's products. Of these existing and potential competitors, a number have greater financial, marketing and technological resources than the Company. To date, most of the Company's revenues have been derived from sales of products that operated under the MS-DOS operating systems of Microsoft Corporation ("Microsoft"). One developer of a compatible operating system has licensed a competitive data compression product for incorporation into the latest version of its operating system. *There can be no assurance that Microsoft or personal computer manufacturers will not incorporate a competitive data compression technology in their products or that such a technology will not otherwise emerge as an industry standard. . . . Increased competition could result not only in a decline in sales volume but also in price reductions that could have a material adverse effect on the Company's business, operating results and financial condition.*

This risk factor language was itself false and misleading because:

(a) Stac had learned that Microsoft had decided to include data compression capability ("DoubleSpace") in its next version of its MS-DOS operating system which

Microsoft intended to announce and introduce as soon as possible in 1992;

(b) Stac was taking action to delay Microsoft's announcement that it had decided to include data compression capability in its enhanced MS-DOS operating system to be introduced as soon as possible in 1992; and

(c) Demand for Stac's main compression data products (Stacker 2.0) had weakened, in part due to the introduction of a new and successful competitive product, and that in order to stimulate sales of its products prior to the end of the March 31, 1992 quarter, Stac was granting special sales incentive terms (including price discounts and rights of return) beyond those it normally granted in the ordinary course of business.

59. The Prospectus contained the following "Risk Factor" language concerning Stac's Stacker product:

> *Dependence on Stacker . . . Product Concentration.* To date, most of the Company's revenues have derived from sales of its Stacker products. The Company introduced the initial version of its Stacker products in December 1990, followed by version 2.0 in September 1991. Sales of Stacker products have grown rapidly and represented $6,202,000 or 74% and $15,310,000 or 90% of the Company's revenues in fiscal 1991 and the first six months of fiscal 1992, respectively. *The Company expects that sales of these products will continue to be a substantial majority of the Company's revenues. The Company does not yet have sufficient marketing history with respect to Stacker products to predict whether the market for these products will continue to grow or at what rate.* In addition, the Company's Stacker products are

> designed for use with personal computers running MS-DOS or compatible operating systems. *Although the Company intends to develop and introduce products for other operating systems, future sales of the Company's existing Stacker products are dependent upon continued use of the MS-DOS operating system.* The development of new operating systems or improvement of existing operating systems that compete with MS-DOS and the market acceptance of such systems could adversely affect sales of the Company's products. . . . Thus, *there can be no assurance that the Company will sustain its recent rate of revenue growth or maintain profitability.* Any overall decline in sales of Stacker products could have a material adverse effect on the Company's business, operating results and financial condition.

This risk factor language was false and misleading because:

(a) Stac had learned that Microsoft had already decided to include (at no extra cost) data compression capability ("DoubleSpace") in its next version of its MS-DOS operating system which it intended to announce and introduce as soon as possible in 1992;

(b) Demand for Stac's main compression data products (Stacker 2.0) had weakened, in part due to the introduction of a new and successful competitive product, and that in order to stimulate sales of its products prior to the end of the March 31, 1992 quarter, Stac was granting special sales incentive terms (including price discounts and rights of return) beyond those it normally granted in the ordinary course of business;

(c) In order to stimulate sales of its products at the end of the quarter ended March 31, 1992, Stac was granting special discount prices to selected customers which, combined with price cuts which Stac anticipated making publicly, would trigger substantial liability of Stac under the price protection agreements it had with its customers;

(d) Stac had achieved strong revenue and net income growth in its second quarter of fiscal 1992 ended March 31, 1992, not because its Stacker 2.0 data compression product had received favorable publicity in trade publications and awards; but rather, due to the special price discounts and sales terms referred to above;

(e) Stac had "borrowed" sales from future periods in order to artificially inflate sales of data compression products prior to March 31, 1992, and Stac knew Microsoft would soon be announcing and introducing an enhanced MS-DOS operating system which included data compression capability and therefore Stac knew that its revenues and net income would decline in future periods;

(f) That because of the factors set forth above, Stac's business had peaked and entered a period of protracted decline, whereby the Company's profits and earnings per share would decline to levels well below those achieved in the recent past;

(g) Stac's business had entered an extremely difficult period characterized by increased competition and decreased selling prices for Stac's products, such that Stac would suffer significant declines in its business;

(h) Stac's main product line – data compression products – would soon be severely disadvantaged in the marketplace by Microsoft's announcement and introduction of an improved MS-DOS operating system that would include data compression capability at no additional cost, thus ending Stac's ability to achieve continued profitable growth; and

(i) Stac's profits had peaked during the first quarter of calendar 1992 and because of the factors stated above, had entered a period of protracted decline.

60. The Prospectus contained the following "Risk Factor" language concerning Stac's future results:

> *Quarterly Fluctuations.* The Company has historically experienced significant *fluctuations* in its operating results, including net income, and anticipates that these *fluctuations* will continue. The Company operates with relatively little backlog, and the majority of its revenues in each quarter results from orders received in that quarter. Consequently, *if* near-term demand for the Company's products weakens in a given quarter, the Company's operating results for that quarter would be adversely affected. Quarterly results have been and may in the future be influenced by distributor ordering patterns, the timing of announcements or introductions of new products and product upgrades by the Company or competitors, product returns, delays in product development, or licensing of the Company's core technology. During the first six months of fiscal 1992 the Company's distributors and software reseller returned substantial quantities of the initial version of Stacker in exchange for version 2.0 of Stacker. Such returns

did not materially impact operating results for the first six months of fiscal 1992, however, as allowances for returns of the initial version of Stacker had been established in fiscal 1991. Fluctuations could also be caused by seasonal factors. As a result, the Company believes that period-to-period comparisons of its operating results should not be relied upon as an indication of future performance.

This risk factor language was false and misleading because:

(a) Stac had "borrowed" sales from future periods in order to artificially inflate sales of data compression products prior to March 31, 1992, and because Stac knew Microsoft would soon be announcing and introducing an enhanced MS-DOS operating system which included data compression capability and that Stac knew that its net income would decline (not fluctuate) in future periods;

(b) That because of the factors set forth above, Stac's business had peaked and was entering a period of protracted decline, whereby the Company's profits and earnings per share would decline well below the levels achieved in the recent past;

(c) Stac's business had entered an extremely difficult period characterized by increased competition and decreased selling prices for Stac's products, such that Stac would suffer significant declines in its business;

(d) Stac's main product line – data compression products – would soon be severely disadvantaged in the marketplace by Microsoft's announcement and introduction of an improved MS-DOS operating system that

would include data compression capability at no additional cost, thus ending Stac's ability to achieve continued profitable growth; and

(e) Stac's profits had peaked during the first quarter of calendar 1992 and because of the factors stated above, had entered a period of protracted decline.

61. After the Offering, Stac remained in constant contact with Alex. Brown and Montgomery and worked with them to support (inflate) the price of Stac stock in the aftermarket through the issuance of false securities analysts' reports and other false statements to the effect that Stac's business prospects and financial condition were strong and that Stac would achieve substantially increased revenues and earnings in the fiscal years to end September 30, 1992 and 1993, respectively.

62. On June 2, 1992 – just after the expiration of the SEC mandated 25-day quiet period following an initial public offering, Alex. Brown issued a report on Stac which was widely circulated to Alex. Brown brokers, customers and was publicly available. The report stated:

> Investment Conclusion: Strong Buy
>
> We are initiating research coverage of Stac Electronics with an investment rating of "strong buy." STAC Electronics is the leading developer of data-compression software for personal computers. The Company's Stacker 2.0 product provides end-users with two hard-disk doubling solutions, software only and software plus silicon, both based on a patented data-compression algorithm. Stacker works seamlessly with other applications and preserves data integrity. It is

the Company's goal to make its technology the industry standard for data compression.

We are setting earnings estimates as follows:

	EPS	Y/Y Change	Revenue (mil.)
3Q 1992	$0.15	NM	$12.0
4Q 1992	$0.18	NM	$14.5
FY 1992	$0.55	NM	$43.5
1Q 1993	$0.18	385.0%	$15.5
2Q 1993	$0.20	10.4%	$17.5
3Q 1993	$0.20	35.3%	$19.0
4Q 1993	$0.24	35.2%	$22.5
FY 1993	$0.82	49.4%	$74.5
FY 1994	$1.15	40.4%	$110.0

* * *

We believe that the data-compression software market will be a very attractive one. . . .

* * *

We believe that Stac Electronics is well-positioned to take advantage of this market opportunity. We estimate that Stacker has a potential customer base of 40 million PC owners. In our opinion, Stac Electronics is the best-poised Company to exploit the data-compression market's opportunities because of the following.

* * *

- *Protected, Proprietary Technology* – patents protect key algorithms, adding to the difficulty of duplicating the Company's technology.

63. On or about June 2, 1992, Montgomery also "initiated coverage" of Stac by issuing an "aggressive buy" recommendation via a research report which was widely circulated to Montgomery brokers, customers and was publicly available. It stated:

> We have initiated coverage of Stac Electronics (Stac) with a rating of 1 (Aggressive Buy) because *the company's dominant position in the underpenetrated and rapidly growing market for data compression products and strong development capabilities should enable it to emerge as one of the leading players in the computer software industry.* Over the last five years Stac has evolved from a contract research and development shop to a developer of error-correction and data compression chips for the tape drive market to the leading vendor of data compression software for the PC. Since the release of the initial version of Stacker during the fall of 1990, and the release of version 2.0 in the fall of 1991, the company's product has won every major industry award in the data compression software category and scored very favorably in product comparisons. In 1992 the company plans to leverage its success in the DOS market into the OS/2 market. Although it is likely that powerful competitors could enter this underpenetrated and rapidly growing market, we believe that *the company has the critical resources – an established brand name, an installed base of 300,000, strong technical development capabilities, solid management and a recently enriched balance sheet – necessary to sustain its recent success.*

The Montgomery report forecast fiscal 1992 and 1993 earnings per share of $.52 and $.74, respectively.

64. The Alex. Brown and Montgomery reports issued on June 2, 1992 were false and misleading and the projections contained therein lacked any reasonable basis and were not genuinely believed by defendants because:

(a) Stac did not have the critical resources to sustain its recent success because demand for its Stacker 2.0 product had weakened substantially and Microsoft was going to include data compression capability in its next upgrade of its MS-DOS operating system, which would decimate sales of Stac's data compression products;

(b) Stac did not have a dominant position in the market for data compression products that would enable it to emerge as one of the leading players in the computer software industry because demand for its Stacker 2.0 product had weakened substantially and Microsoft was going to include data compression capability in its next upgrade of its MS-DOS operating system, which would decimate sales of Stac's data compression products;

(c) Stac was not well-positioned to take advantage of the opportunities in the data compression market because demand for its Stacker 2.0 product had weakened substantially and Microsoft was going to include data compression capability in its next upgrade of its MS-DOS operating system, which would decimate sales of Stac's data compression products;

(d) Stac was not the best poised company to exploit the data compression market opportunities because demand for its Stacker 2.0 product had weakened substantially and Microsoft was going to include data compression capability in its next upgrade of its MS-DOS

operating system, which would decimate sales of Stac's data compression products; and

(e) Stac's data compression algorithm was not really proprietary and was not adequately protected by patents.

65. The June 2, 1992 reports of Alex. Brown and Montgomery were issued pursuant to an agreement between Stac, Stac insiders and the Underwriters that the Underwriters would issue very positive reports on Stac, including forecasts of future earnings growth, in return for being selected as the underwriters for the public offering. Stac's top officers worked with Alex. Brown and Montgomery to create the June 2 reports and provided the financial forecast data for inclusion in those reports. The information about Stac contained in those analysts' reports was obtained from or based on information obtained from the Company. Copies or drafts of those analysts' reports were provided to the Company before they were released. Thus, the Company and its top officers knew of the contents of these reports, knew that they were based on information provided by the Company and knew that they would be publicly issued and affect the trading price of the Company's stock, and thus they adopted those reports as their own.

66. Responding to these favorable reports and positive projections, *inter alia*, the price of Stac stock climbed to a high of $15-3/4 per share in early June 1992. On July 1, 1992, just after the close of Stac's third quarter of fiscal 1992 and shortly following an announcement by Quarterdeck Office Systems, another computer software company, of poor third quarter results, the market price of

Stac stock unexpectedly fell. Defendant Clow reassured the market by stating to the *Dow Jones News Wire* that *"there aren't any corporate developments at the company,"* and that the Quarterdeck announcement was the probable cause of Stac's price decline. Montgomery and Alex. Brown analysts also stated to the *Dow Jones News Wire* that Quarterdeck's problems did not signal trouble for Stac. Montgomery stated that "Stac is a leader in an emerging market. There's no similarity [with Quarterdeck] other than the fact that Stac and Quarterdeck are both one- or two-product (software) utility companies." Alex. Brown stated that Stac's compression software *"continues to just fly off the shelves."* These statements were false and misleading because the true facts, which were not disclosed, were:

(a) That in order to stimulate sales of its products at the end of the quarter ended March 31, 1992, Stac had given special discount prices to selected customers which, combined with price cuts which Stac anticipated making publicly, would trigger substantial liability of Stac under the price protection agreements it had with its customers;

(b) That Stac had achieved strong revenue and net income growth in its second quarter of fiscal 1992 ended March 31, 1992, not because its Stacker 2.0 data compression product had received favorable publicity in trade publications and awards; but rather, due to special price discounts and rights of return different from those it normally offered in the underlying course of business;

(c) Because Stac had "borrowed" sales from future periods in order to artificially inflate sales of data

compression products prior to March 31, 1992, and because Stac knew Microsoft would soon be announcing and introducing an enhanced MS-DOS operating system which included data compression capability, Stac knew that its revenues and net income would decline in future periods;

(d) By July 1, 1992, certain Stac customers had begun to return products to Stac due to continued slowing sales of Stacker 2.0, which was hurting Stac's revenues and net income; and

(e) By July 1, 1992, Stac sales were slowing dramatically due to software demand for and increased return of Stac's products, resulting in Stac's revenues and net income falling from the March 31, 1992 quarter and being well below plan.

67. On July 6, 1992, Montgomery issued a research report on Stac which indicated that it believed Stac's third quarter sales and earnings would not increase as much as earlier forecast. However, the Montgomery analyst attributed this to "a general slowdown in PC software sales," as opposed to any problem with Stac and "says her earnings estimate reductions for Stac Electronics shouldn't be interpreted by the financial community . . . as any indication the company 'stuffed' its distribution channel in the March quarter," as the March quarter sales "jump . . . reflects the Company's shipment in the March 1992 quarter of a new product that received glowing trade press reviews." These statements were false and misleading, as the true facts, which were not disclosed, were:

(a) Demand for Stac's main compression data products (Stacker 2.0) had weakened, in part due to the introduction of a new and successful competitive product, and that in order to stimulate sales of those products, Stac was granting special sales incentive terms including price discounts and rights of return beyond those it normally granted in the ordinary course of business;

(b) That in order to inflate the revenues and net income Stac reported for the quarter and the six months ended March 31, 1992, Stac had induced certain of its customers to order extra merchandise on special consignment terms, which it did not grant in the ordinary course of business, and which were not bona fide sales;

(c) That in order to stimulate sales of its products at the end of the quarter ended March 31, 1992, Stac was offering special discount prices to selected customers which, combined with price cuts which Stac anticipated making publicly, would trigger substantial liability of Stac under the price protection agreements it had with its customers;

(d) That Stac had achieved strong revenue and net income growth in its second quarter of fiscal 1992 ended March 31, 1992, not because its Stacker 2.0 data compression product had received favorable publicity in trade publications and awards; but rather, due to the special price discounts and sales terms referred to above;

(e) Because Stac had "borrowed" sales from future periods in order to artificially inflate sales of data compression products prior to March 31, 1992, and because Stac knew Microsoft would soon be announcing and introducing an enhanced MS-DOS operating system

which included data compression capability, Stac knew that its revenues and net income would decline in future periods;

(f) By July 1, 1992, certain Stac customers had begun to return products to Stac due to continued slowing sales of Stacker 2.0, which was hurting Stac's revenues and net income; and

(g) By July 1, 1992, Stac sales were slowing dramatically due to software demand for and increased return of Stac's products, resulting in Stac's revenues and net income falling from the March 31, 1992 quarter and being well below plan.

68. The next day, on July 7, 1992, Alex. Brown issued a report on Stac which maintained its positive 1992 and 1993 earnings estimates of $.55 and $.82 per share, respectively. The Alex. Brown report stated:

> As many software companies are preannouncing disappointing June quarter results, fears are growing among investors that factors influencing some software vendors will uniformly impact all vendors. *We do not believe that this is the case for Stac Electronics and we maintain our "strong buy" rating and current estimates.*

The information about Stac contained in this report was obtained from or based on information obtained from Stac and its top officers and copies of drafts of this report were provided to Stac and its top officers before it was released; thus Stac knew of the report, its contents, that it was based on information provided by Stac, and that it would be issued to members of the investing public, be circulated throughout the investment community and

impact the trading price of Stac common stock and thus adopted the report as their own. The statements in this report were false and misleading and the projections contained therein lacked any reasonable basis and were not genuinely believed by the defendants. The true facts, which were not disclosed, were:

(a) That in order to stimulate sales of its products at the end of the quarter ended March 31, 1992, Stac was operating special discount prices to selected customers which, combined with price cuts which Stac anticipated making publicly, would trigger substantial liability of Stac under the price protection agreements it had with its customers;

(b) That Stac had achieved strong revenue and net income growth in its second quarter of fiscal 1992 ended March 31, 1992, not because its Stacker 2.0 data compression product had received favorable publicity in trade publications and awards; but rather, due to the special price discounts and sales terms referred to above;

(c) Because Stac had "borrowed" sales from future periods in order to artificially inflate sales of data compression products prior to March 31, 1992, and because Stac knew Microsoft would soon be announcing and introducing an enhanced MS-DOS operating system which included data compression capability, Stac knew that its revenues and net income would decline in future periods; and

(d) That because of the factors set forth above, Stac's business had peaked and was entering a period of protracted decline, whereby the Company's profits and

earnings per share would decline to levels well below those achieved in the recent past.

69. Contrary to these false statements and assurances, only two weeks later, on July 20, 1992, Stac suddenly revealed that sales of Stacker products had fallen in the third quarter ended June 30, 1992, declining from the second quarter ended March 31, 1992. Stac's revenues for the quarter were $10 million, compared to $11.6 million in the prior quarter, while net income was only $2.76 million, compared to $4.21 million in the prior quarter or $.11 per share, compared to $.17 and that its sales and net income would continue to decrease in the next quarter. Stac's net income decline was due, in part, to inventory writedowns for returned Stac products that had been sold prior to the end of the March 3, 1992 quarter with special rights of return. Thus, Stac was required in its third quarter of fiscal 1992 to write down what it had falsely represented were and were reported as sales and profits in the quarter immediately prior to the Offering, and to take writedowns reflecting, *inter alia*, what should have been reserved in that prior quarter. In response to these revelations, the market price of Stac common stock, which had climbed to over $15 following the Offering, plummeted to $5.50 per share and continued to decline to just $3 per share by September 1992 and ultimately as low as $1-3/4 per share.

70. Stac's business has continued to decline, reflecting the poor sales of its Stacker 2.0 product due to the success of competitive products and Microsoft's announcement of its enhanced MS-DOS 6.0 operating system which contained data compression capabilities ("DoubleSpace"), which has decimated the market for

Stac's data compression products. On October 29, 1992, the Company announced that its fourth quarter revenue had declined to $6,245,000, its net income fell to $526,000 and its earnings per share to just $.02, again due to declining sales of Stacker 2.0. In this quarter, Stac continued to suffer impaired earnings as it incurred special charges due to the continued return of product sold with special rights of return prior to March 31, 1992, and due to price protection obligations incurred due to price cuts it was making to try to stimulate sales of its products. During fiscal 1992 (October 1, 1991-September 30, 1992), Stac continued to report poor results well below those achieved in the period ending March 31, 1992 and ultimately laid off 20% of its employees and contracted the size of its business due to declining sales of Stacker. After suffering losses in the third and fourth quarters of fiscal 1993, Stac managed to earn just $.02 per share for all of fiscal 1993. The full extent of the terrible decline in Stac's business since the public offering is shown by the following chart:

	Quarter Ended (All amounts in thousands, except EPS)							
	12/31/91	3/31/92	6/30/92	9/30/92	12/31/92	3/31/93	6/30/93	9/30/93
Revenue	$5,393	$11,664	$10,000	$ 6,200	$12,300	$11,000	$ 5,700	$ 7,700
Net Income	857	4,200	2,700	526	2,100	1,000	(2,300)	(420)
Earnings Per Share	N/A	.17	.11	.02	.08	.04	(.10)	(.02)

71. The information concealed by defendants is the type of information which is material to investors and the securities markets:

(a) In addition to the periodic reports required under the Exchange Act, management of a public company has a duty promptly "to make full and prompt announcement of material facts regarding the company's financial condition." Release No. 34-8995 (Oct. 15, 1970), 17 C.F.R. §241.8995. The SEC has repeatedly stated that the provisions of the federal securities laws, which are intended to ensure that the investing public is provided with "complete and accurate information about companies whose securities are publicly traded," apply to all public statements by persons speaking on behalf of publicly traded companies "that can reasonably be expected to reach investors and the trading markets, whoever the intended audience." Release No. 33-6504 (January 13, 1984), 17 C.F.R. §241.20560. The SEC has emphasized that "investors have legitimate expectations that public companies are making and will continue to make prompt disclosure of significant corporate developments." Release No. 18271 (November 19, 1981) [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶83,049;

(b) Schedule D of the National Association of Securities Dealers ("NASD") Manual which governs companies whose securities are included in the NASDAQ National Market System, requires a NASDAQ company to "make prompt disclosure to the public through the press of any material information that may affect the value of its securities or influence investors' decisions." NASD Manual, Schedule D, Part II, §1(c)(13) [¶1803 (c)(13)];

(c) The New York Stock Exchange ("NYSE") Manual provides that a public company listed on the NYSE "is expected to release quickly to the public any news or information which might reasonably be expected to materially affect the market for its securities. This is one of the most important and fundamental purposes of the listing agreement which the company enters into with the Exchange." NYSE Manual §202.05; and

(d) The American Stock Exchange ("AMEX") Guide, governing securities listed on the AMEX, provides "the conduct of a fair and orderly market requires every listed company to make available to the public information necessary for informed investing and to take reasonable steps to ensure that all who invest in its securities enjoy equal access to such information." AMEX Guide §401.

72. While the false and misleading prospectus was in effect, the Individual Defendants sold 538,000 shares of Stac stock they owned for proceeds of $6,456,000 to profit from the artificial inflation in the Stac stock price their fraud created. Notwithstanding their access to confidential information as a result of their status as directors and/or officers of the Company and their corresponding duty to disclose the adverse material facts set forth herein, the Individual Defendants sold or otherwise disposed of significant amounts of Stac shares at artificially inflated prices throughout the Class Period. Of the 3 million shares offered in the May 7, 1992 public offering, 1.5 million shares were sold by insiders, including certain Individual Defendants as follows:

Officer, Director	Shares Sold in Offering	Proceeds
Gary W. Clow	200,000	$2,400,000
Douglas L. Whiting	200,000	$2,400,000
Robert W. Johnson	100,000	$1,200,000
Arthur J. Collmeyer	8,000	96,000
John R. Witzel	30,000	$ 360,000
	538,000	$6,456,000

STAC'S FALSE FINANCIAL STATEMENTS

73. In order to report substantially increased revenues and earnings to inflate the price of its stock in the public offering, Stac and its insiders manipulated Stac's reported revenues and earnings for the period ended March 31, 1992, through improper practices in violation of Generally Accepted Accounting Principles ("GAAP"). As a result of these improper practices, Stac's financial statements for the first six months of fiscal 1992, ended March 31, 1992, did not fairly present Stac's financial condition and results from operations in conformity with GAAP. In fact, those results were materially false and misleading in that revenues, net income, net income per share, and retained earnings as reported were improperly and materially inflated.

74. Financial Accounting Standards Bulletin ("FASB") 48, paragraph 7 states: "Sales revenue and cost of sales reported in the income statement shall be reduced to reflect estimated returns." Because it created extra "sales" of March 31, 1992 by extending special rights of return to customers, Stac knew that significant

amounts of Stacker product would be returned. Stac also knew that its reserves for returns was not accurate or adequate and had not resulted in the creation of adequate reserves. Nevertheless, Stac made no material change in the manner in which reserves were created and computed because to do so would have reduced the revenue and net income growth Stac's insiders wanted Stac to report at March 31, 1992 and impaired its image as a company on a rapid growth track. In addition, during the quarter ended March 31, 1992, Stac improperly recognized revenue by recording as sales, shipments of Stacker 2.0 that were not bona fide sales, but rather, consignments whereby the customers had the ability to return the product if it was not sold. Finally, Stac failed to record adequate liabilities for its price protection obligations to its customers at March 31, 1992, which it knew existed as of that date.

75. As a result of the improper and misleading accounting practices set forth above, Stac's March 31, 1992 financial statements, which were publicly disseminated during the Class Period were materially false and misleading in that they were not prepared in accordance with GAAP, and the quarterly financial statements were not prepared pursuant to the rules and regulations of the SEC or in accordance with GAAP. As a result, these financial statements did not reflect all adjustments necessary to present fairly the financial position, results of operations and changes in the financial position of Stac's revenues and net earnings, which were overstated in material amounts for the periods presented.

CLAIM FOR RELIEF I

Against All Individual Defendants, The Underwriters and The Venture Capital Defendants For Violations of §11 of the Securities Act

76. Plaintiffs incorporate by reference ¶¶1-75 except allegations of fraud. This Count is asserted against Stac and all defendants who signed or controlled a person who signed the Registration Statement for Stac's May 7, 1992 Offering and the underwriters of the May 7, 1992 Offering.

77. Defendants are signatories of the Registration Statement and/or controlling persons of the issuer, Stac, or Underwriters of the Registration Statement. They owed purchasers of the stock the duty to make a reasonable investigation of the statements contained in the Registration Statement and Prospectus to ensure that said statements were true and that there was no omission to state any material fact required to be stated in order to make the statements contained therein not misleading. Defendants knew or, in the exercise of reasonable care, should have known of the material misstatements and omissions contained in the Registration Statement and Prospectus as set forth herein. None of the defendants made a reasonable investigation or possessed reasonable grounds for the belief that statements contained in the Registration Statement and Prospectus were true or that there was not any omission of material fact necessary to make the statements made therein not misleading.

78. By reason of the conduct herein alleged, each defendant violated, and/or controlled a person who violated, §11 of the Securities Act to the damage of plaintiffs and the Class.

79. This action was brought within one year after the revelations of July 20, 1992, which led to the discovery of the untrue statements and omissions and within three years after Stac stock was offered to the public.

CLAIM FOR RELIEF II

Against All Individual Defendants and The Venture Capital Defendants For Violation of §15 of The Securities Act

80. Plaintiffs incorporate ¶¶1-79 as if set forth fully herein.

81. The defendants named in this Claim for Relief acted as controlling persons of the Company within the meaning of §15 of the Securities Act. By reason of their senior management positions and/or directorships or stock ownership, as alleged above, these defendants had the power to influence and exercised the same to cause Stac to engage in the unlawful acts and conduct complained of herein. The Venture Capital firm defendants each controlled their respective representative on Stac's Board and had the power to influence and exercised the same to cause Stac to engage in the unlawful acts and conduct complained of herein.

82. By reason of such control, the defendants named in this Claim for Relief are liable pursuant to §15 of the Securities Act. As a direct and proximate result of these

defendants' wrongful conduct, plaintiffs and the other members of the Class suffered damages in connection with their purchases of the Company's common stock during the Class Period.

CLAIM FOR RELIEF III

Against All Defendants For Violations of §10(b) Of The Exchange Act And SEC Rule 10b-5

83. Plaintiffs incorporate ¶¶1-82. This Count is asserted against all defendants.

84. The following conspiracy, aiding and abetting and concerted action allegations, ¶¶84-90 are made on information and belief, based upon the existence of the material adverse facts alleged in ¶¶44, 49, 51, 53, 55, 58-60, 64, 66-68, 73-75 hereof; the defendants' access to and knowledge of those facts; each defendants' failure to disclose the material adverse facts alleged in ¶¶44, 49, 51, 53, 55, 58-60, 64, 66-68, 73-75, despite their knowledge of those facts; the benefits gained by the defendants in conducting the fraud alleged herein (as discussed in, *inter alia*, ¶72 hereof); the Individual Defendants' positions as executive officers and/or directors of Stac; and meetings of Stac directors and officers at which the directors and officers discussed the business and affairs of Stac. In committing the wrongful acts alleged herein, all of the defendants have pursued a common course of conduct and acted in concert with and conspired with one another, in furtherance of their common plan, scheme or design. In addition to the wrongful conduct herein alleged as giving rise to primary liability, defendants

further aided and abetted and knowingly assisted each other in breach of their respective duties as herein alleged.

85. During all relevant times hereto, defendants, and each of them, initiated and/or joined in the course of conduct which was designed to and did (i) deceive the investing public, including plaintiffs and other class members regarding Stac's products, markets, demand for its products, finances, financial condition and present and future business prospects; (ii) artificially inflate the market price of Stac common stock during the Class Period; (iii) cause plaintiffs and other members of the Class to purchase or otherwise acquire Stac common stock at inflated prices; and (iv) permit certain defendants to sell large amounts of their Stac common stock at inflated prices. In furtherance of this plan, conspiracy and course of conduct, defendants, and each of them, took the actions as herein set forth.

86. Defendants engaged in a conspiracy, common enterprise or common course of conduct, commencing at least by March 1992, in violation of the federal securities law for the purpose and effect of which was, *inter alia*, to optimistically and falsely present the Company's financial condition and future business prospects. The defendants engaged in such a scheme so that they could inflate the price of the Company's common stock in order to: (i) protect and enhance their executive positions and the substantial compensation and prestige they had obtained thereby; (ii) enhance the value of their personal Stac securities holdings and options; (iii) sell shares of Stac common stock they owned at inflated prices to obtain large amounts of cash and large profits and/or avoid

significant losses; (iv) inflate the reported profits of the Company in order to obtain large payments under Stac's incentive bonus compensation plan and/or *via* discretion in the individual performance bonuses.

(a) All of the defendants engaged in a conspiracy, common enterprise or common course of conduct commencing in March of 1992, the purpose and effect of which was, *inter alia*, to prolong the illusion of Stac's continued growth and to make it appear that Stac's Stacker 2.0 was very successful and thereby artificially inflating the price of Stac's common stock in violation of the anti-fraud provisions of the federal securities laws. Defendants accomplished their conspiracy, common enterprise or common course of conduct of artificially inflating the price of Stac common stock through the issuance of a misleading Prospectus and Registration Statement and a series of interrelated and interdependent false reports and press releases to the public, which misrepresented and failed to disclose the true facts regarding Stac's products, markets and present and future business prospects and created a false impression of continuing growth and record profitability.

(b) In addition, certain of the Individual Defendants all benefitted from the illegal course of conduct by selling Stac stock owned by them at artificially inflated prices without disclosing the material, adverse and non-public facts about Stac to which they were privy, despite their duty to disclose all material adverse facts or refrain from selling Stac stock. Each defendant was a direct, common, necessary and substantial participant in the conspiracy, common enterprise or common course of conduct complained of herein.

87. Each of the named defendants herein aided and abetted and rendered substantial assistance in the wrongs complained of herein. In taking the actions, as particularized herein, to substantially assist the commission of the fraud complained of, each defendant acted with knowledge of the primary wrongdoing, substantially assisted the accomplishment of that fraud, and was aware of his overall contribution to and furtherance of the fraud. Defendants' acts of aiding and abetting include, *inter alia*, the acts they are alleged to have committed in furtherance of the conspiracy, common enterprise, and common course of conduct complained of herein, except those relating to the reaching of agreements or understandings sufficient to categorize their conduct as conspiratorial.

88. Each of the defendants either knew or recklessly disregarded the fact that the illegal acts and practices and misleading statements and omissions described herein would adversely affect the integrity of the market for Stac's common stock and would artificially maintain the prices of those securities. Each of the defendants, by acting as herein described, did so knowingly or in such a reckless or grossly negligent manner as to constitute a fraud and deceit upon plaintiffs and members of the Class plaintiffs seek to represent.

89. The foregoing statements of defendants misrepresented the true financial and operating condition and future prospects of Stac and failed to disclose material facts necessary to make the statements made, in the context in which they were made, not misleading, in violation of §10(b) of the Exchange Act and SEC Rule 10b-5. These reports made untrue statements of material facts

and omitted to state material facts necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading. The defendants are also liable under §10(b) and Rule 10b-5 as controlling persons pursuant to §20(a) of the Exchange Act.

90. During the Class Period, the defendants, individually and in concert, directly and indirectly, engaged and participated in or aided and abetted a continuous course of conduct to conceal adverse material information regarding Stac. Defendants employed devices, schemes, and artifices to defraud and engaged in acts, practices, and a course of conduct as hereinafter alleged in an effort to maintain artificially high market prices for Stac stock. This included the formulation, making of and/or participation in the making of untrue statements of material facts and omitting to state material facts necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, and engaging in acts, practices and courses of business which operated as a fraud and deceit upon members of the Class.

91. Each of the defendants, by acting as hereinabove described, did so knowingly or in such a reckless manner as to constitute a fraud upon the Class. With knowledge or reckless disregard of the true financial and operating condition of Stac, the defendants caused the reports, statements and releases to contain misstatements and omissions of material fact as alleged herein.

92. In ignorance of the adverse facts and relying upon the integrity of the market in Stac's stock, plaintiffs

and the members of the Class acquired the Company's stock at artificially inflated prices and were damaged thereby.

93. Had plaintiffs and the members of the Class known of the materially adverse information which was not disclosed by defendants, they would not have purchased the Company's stock at all or, if so, not at the artificially inflated prices they did and sustained damages thereby.

CLAIM FOR RELIEF IV

Against All Individual Defendants and The Venture Capital Defendants For Violation of §20(a) of The Exchange Act

94. Plaintiffs incorporate ¶¶ 1-93 as if set forth fully herein.

95. The defendants named in this Claim for Relief acted as controlling persons of the Company within the meaning of §20(a) of the Exchange Act. By reason of their positions as senior officers and/or directors or stockholders as alleged above, these defendants had the power and authority to cause the Company to engage in the wrongful conduct complained of herein. The Venture Capital Defendants each controlled their respective representative on Stac's Board and had the power to influence and exercised the same to cause Stac to engage in the unlawful acts and conduct complained of herein.

96. By reason of such wrongful conduct, defendants are liable pursuant to §20(a) of the Exchange Act. As a direct and proximate result of the defendants' wrongful

conduct, plaintiffs and the other members of the Class suffered damages in connection with their purchases of the Company's common stock during the Class Period.

PRAYER FOR RELIEF

WHEREFORE, plaintiffs pray for judgment:

1. Declaring this action to be a proper class action pursuant to Rule 23(a) and 23(b)(3) of the Federal Rules of Civil Procedure on behalf of the Class defined herein;

2. Awarding plaintiffs and the members of the Class compensatory damages;

3. Awarding plaintiffs and the members of the Class, pre-judgment and post-judgment interest, as well as their reasonable attorneys' fees, expert witness fees and other costs and expenses for this litigation;

4. Extraordinary equitable and/or injunctive relief as permitted by law, equity and federal and state statutory provision sued hereunder, including attaching, impounding, imposing a constructive trust upon or otherwise restricting the proceeds of defendants' trading activities or their other assets so as to assure that plaintiffs and the Class have an effective remedy; and

5. Awarding such other relief as this Court may deem just and proper.

JURY DEMAND

Plaintiffs demand a trial by jury.

DATED: November 18, 1993

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Supreme Court
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No. 96-845

In The

Supreme Court of the United States

October Term, 1996

TIMOTHY J. ANDERSON, NEIL SINGER and ARTHUR SINGER, On Behalf of Themselves and All Others Similarly Situated,

Petitioners,

v.

GARY W. CLOW, DOUGLAS L. WHITING, ROBERT W. JOHNSON, ARTHUR J. COLLMEYER, JOHN R. WITZEL, and STAC ELECTRONICS, INC.,

Respondents.

On Petition For Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. Whether this Court should accept for review a case decided under law largely superceded by the Private Securities Litigation Reform Act of 1995 and which presents no important question of law on which the United States Courts of Appeal have issued conflicting opinions?

2. Whether the "bespeaks caution" doctrine applies to claims asserted under the Securities Act of 1933 and the Securities Exchange Act of 1934 and, if so, whether the Ninth Circuit properly applied the doctrine?

3. Whether the Ninth Circuit properly affirmed dismissal of a complaint under the Securities Act of 1933 and the Securities Exchange Act of 1934 where the allegedly omitted facts were actually disclosed in the very documents alleged to have been misleading?

4. Whether Federal Rules of Civil Procedure Rule 9(b) applies to claims under Section 11 of the Securities Act where the gravamen of such claims is fraud?

OTHER PARTIES

In addition to respondents, Alex. Brown & Sons, Inc. and Montgomery Securities also appeared as defendants-appellees before the Ninth Circuit below. The following individuals and entities were parties to the proceedings in the Ninth Circuit but were dismissed by plaintiffs during the pendency of the appeal: Lawrence G. Finch, Robert A. Hoff, Russell j. Robelen, Sigma Partners, Sigma Management, Sigma Management II, L.P., Crosspoint Venture Partners and Idanta Partners.

DISCLOSURE PURSUANT TO RULE 29.6

Stac Electronics, Inc. has no parent corporation. Stac Electronics, Inc. has one non-wholly owned subsidiary, hi/fn Inc.

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BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

Respondents Gary W. Clow, Douglas L. Whiting, Robert W. Johnson, Arthur J. Collmeyer, John R. Witzel and STAC Electronics, Inc. ("Stac") respectfully oppose the petition of Timothy J. Anderson, Neil Singer and Arthur Singer for a writ of certiorari.

OPINIONS BELOW

Petitioners correctly set out the opinions below.

INTRODUCTION AND SUMMARY OF ARGUMENT

There is no issue presented by this case worthy of this Court's attention. The decisions below were all rendered under the federal securities laws as they existed prior to the enactment of the Private Securities Litigation Reform Act, which significantly changed the law governing the requirements for pleading a securities fraud class action. Any decision in this case, therefore, will have little impact on pending or subsequent cases or the law in general. Moreover, on the one issue Petitioners emphasize – the applicability of Fed. R. Civ. P. 9(b) to claims asserted pursuant to Section 11 of the Securities Act of 1933 – the Circuit Courts are unanimous. There is no conflict among the Circuit Courts for this Court to resolve. The issue, in any event, is not outcome determinative in this case. Likewise, the Ninth Circuit's holding that the pleadings demonstrated that the allegedly omitted facts were actually disclosed by defendants

involves no novel proposition of law. Finally, the Ninth Circuit's holding that the "bespeaks caution" doctrine applied to Stac's prospectus and rendered unactionable its forward-looking statements, including its statements regarding reserves for product returns, is consistent with the rulings of other Circuit Courts and with the express admonition of Congress in enacting the Private Securities Litigation Reform Act encouraging further development of the "bespeaks caution" doctrine.

STATEMENT OF THE CASE

A. Nature of the Case and Proceedings Below.

This is a securities fraud class action brought pursuant to Sections 11 and 15 of the Securities Act of 1933 (the "Securities Act"), 15 U.S.C. § 77k, § 77o; Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 (the "Exchange Act"), 15 U.S.C. § 78j(b), § 78t(a); and Rule 10b-5, 17 C.F.R. 240.10b-5, promulgated under the Exchange Act. The alleged class consists of purchasers of Stac common stock between May 7, 1992 and July 20, 1992 (the "Class Period").

The original complaints were filed on July 23 and 24, 1992 and were twice amended. The second version of plaintiffs' complaint, the Consolidated Amended Class Action Complaint (the "First Amended Complaint") was filed on December 4, 1992. The district court dismissed this complaint with leave to amend on September 17, 1993, in an opinion reported at [1993 Tr. Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,807, at 97,982 (S.D. Cal. Sept. 17,

1993).[1] The court also stayed discovery at that time, almost fourteen months after the original complaints had been filed.

Plaintiffs filed the third version of their claims, the Second Amended Consolidated Class Action Complaint (the "Second Amended Complaint"), on November 18, 1993. Pet. App. at 167a-252a. They named nine new defendants in this complaint. *Id.* at 186a-187a.

All defendants moved to dismiss the Second Amended Complaint. On June 29, 1994, the district court again granted defendants' motions to dismiss in a comprehensive opinion. This time, the dismissal was with prejudice. Following entry of judgment in favor of the defendants in July 1994, plaintiffs appealed to the Ninth Circuit. During the pendency of that appeal, plaintiffs dismissed their claims as to certain defendants.[2] The Ninth Circuit affirmed the judgment of the district court in an opinion issued on May 7, 1996. (Pet. App. at 30a-56a). Plaintiffs sought reconsideration and rehearing *en banc*. The Ninth Circuit panel withdrew its prior opinion and issued a slightly modified opinion on July 17,

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[1] This opinion is in Petitioners' Appendix ("Pet. App.") at 113a-153a.

[2] The defendants against whom the appeal was dismissed are outside directors Lawrence G. Finch, Robert A. Hoff and Russell J. Robelen; and venture capital firms, Sigma Partners, Sigma Management, Sigma Management II, L.P., Crosspoint Venture Partners and Idanta Partners. *See* Stipulations re Dismissal of Appeal as to Certain Claims, filed on April 27, 1995 and May 11, 1995. (Pet. App. at 156a-157a). These individuals and entities had been named as defendants for the first time in the Second Amended Complaint.

1996. The modified opinion is reported at 89 F.3d 1399 (9th Cir. 1996). (Pet. App. at 1a-29a). Plaintiff's subsequent petition for reconsideration and rehearing *en banc* was denied by the Ninth Circuit on August 27, 1996. (Pet. App. at 154a-155a).

B. Statement of Facts.

1. Background.

Stac designs and sells data compression products that increase the capacity of computer storage devices. Second Amended Complaint, Pet. App. 167a *et seq.* at ¶ 46. The Company's award-winning "Stacker" product doubles the storage capacity of disk drives in computers that use Microsoft's MS-DOS and compatible operating systems.[3] *Id.* The Company sells Stacker primarily through distributors. *Id.*

After introducing Stacker in December 1990, Stac's revenues and earnings increased significantly. As the Prospectus disclosed, annual revenues increased from $1.76 million in fiscal 1990 (ended September 30) to $8.39 million in fiscal 1991; earnings improved from a loss of $.05 to a profit of $0.01 per share. *Id.* at ¶ 47. In the six months immediately preceding the May 7, 1992 public offering, the Company's revenues were approximately

---

[3] Stacker received critical acclaim throughout the relevant time period. This acclaim included *PC Magazine's* Technical Excellence Award, *Window Magazine's* Best 100 Windows Products, *PC Magazine's* Editor's Choice Award, *PC Computing's* Award of Distinction, *Byte Week's* Best of COMDEX, and National Software Testing Lab's Recommendation (5 Stars).

$17 million and its earnings were $0.21 per share. *Id.* Stacker accounted for 74% of revenues in fiscal 1991 and 90% of revenues in the first six months of fiscal 1992. *Id.* at ¶ 59.

2. The Public Offering and the Prospectus.

On May 7, 1992, Stac conducted an initial public offering of common stock (the "Offering" or "IPO"). *Id.* at ¶ 45. The prospectus and registration statement pursuant to which the stock was issued (the "Prospectus") summarized Stac's past results and its current business. *Id.* at ¶ 47. The Company was extraordinarily specific about the immediate risks facing the Company. In four pages of risk factors, Stac warned of competition, its dependence on Stacker, technological change and product obsolescence, threats to its intellectual property, its reliance on distributors, its limited source of supply, and the potential volatility of its stock price. Pet. App. at 4a. In addition, the Prospectus expressly warned of Microsoft's competitive threat:

> To date, most of the Company's revenues have derived from sales of products that operate under the MS-DOS operating system of Microsoft Corporation ("Microsoft"). One developer of a compatible operating system has licensed a competitive data compression product for incorporation into the latest version of its operating system. *There can be no assurance that Microsoft or personal computer manufacturers will not incorporate a competitive data compression technology in their products or that such technology will not otherwise emerge as an industry standard.*

Second Amended Complaint, Pet. App. 167a *et seq.* at ¶ 58 (emphasis added). It repeated this disclosure, adding that the products offered by vendors like Microsoft "could render obsolete or adversely affect sales of the Company's products." Pet. App. at 85a.

The Company disclosed not only that it was dependent on Stacker, but also that it did not know whether the market for Stacker would grow, whether the Company could adapt Stacker to changes in new versions of MS-DOS, or whether it could adapt Stacker to the emergence of new operating systems. Second Amended Complaint, Pet. App. 167a *et seq.* at ¶ 59. The Company warned that it typically operates with very little backlog of orders so that quarterly revenues were dependent on distributors' order patterns, which were influenced by product announcements and product development. *Id.* at ¶ 60. It warned that Stac had no control over distributors, who might not support or might cease to carry Stacker. Pet. App. at 79a-80a. The Prospectus described in detail Stac's distributor return policy for older products and its stock balancing programs (whereby distributors may return products for credit toward future purchases). Second Amended Complaint, Pet. App. 167a *et seq.* at ¶ 50. It warned in this regard that "[l]ike other manufacturers of packaged software products, the Company is exposed to the risk of product returns." Pet. App. at 18a. Significantly, Stac stated that, in the six months prior to the Offering, "the Company's distributors and software reseller returned substantial quantities of the initial version of Stacker in exchange for version 2.0." *Id.* Further, Stac expressly warned that its allowance for returns could be materially inadequate:

> Although the Company believes that it provides adequate allowances for returns, there can be no assurance that actual returns in excess of recorded allowances will not result in a material adverse effect on business. . . .

Id. at 19a.

Finally, the Company specifically disclosed that its revenues in the prior quarter may have been influenced by "the phenomenon of 'channel fill' during initial shipments of new versions or new products." Pet. App. at 79a. The Company further stated that it had recently released a new version of Stacker and warned:

> *Channel fill often occurs following the introduction of a new product or a new version* of a product as distributors buy significant quantities of the new product or version in anticipation of sales of such product or version. *Following such purchases, the rate of distributor's* [sic] *purchases may decline.* . . . During the first six months of fiscal 1992 the Company's distributors and software reseller returned substantial quantities of the initial version of Stacker in exchange for version 2.0 of Stacker.

Pet. App. at 18a (emphasis added). Thus, the market was warned that Stac might very well experience a slowdown.

Two and a half months later, when Stac's stock declined on its July 20, 1992 announcement of $0.11 earnings per share (which were below market expectations), plaintiffs filed their securities fraud actions within three days.

3. Plaintiffs' Allegations.

Paragraphs 43-68 of the Second Amended Complaint purport to set forth defendants' alleged misrepresentations and omissions. Pet. App. 167a *et seq.* at ¶¶ 43-68. The Complaint alleges that demand for Stacker was being diminished by consumers' anticipation of a competitive new product (*id.* at ¶¶ 49(3), 53(a), 58(c), 59(b), 67(a)) and that Stac failed to disclose this weakened demand and its "knowledge" that Microsoft would "soon be announcing" a version of MS-DOS that included a "free" data compression product. *Id.* at ¶¶ 44(e), 49(c), 49(i), 49(l), 53(b), 58(a), 59(a), 59(h), 60(d), 64(c)-(d), 67(e). The complaint alleges that by offering special incentives (including price discounts and extended rights of return), Stac "stuffed" its distribution channels in the quarter prior to the IPO (*id.* at ¶¶ 44(a)-(d), 49(e)-(h), 51(a)-(c), 53(c), 58(c), 59(b)-(d), 66(a)-(b), 67(a)-(c), 68(a)-(c)), which resulted in excessive inventories among Stac's distributors (*id.* at ¶¶ 66(d)-(e), 67(f)-(g)), and that Stac had failed to create reserves for this inventory that would be returned to Stac (*id.* at ¶¶ 44(d), 51(b)). The remaining allegations of plaintiffs' 73-page complaint merely repeat this same handful of allegations.

4. The Decision of the Ninth Circuit

In affirming dismissal of the Second Amended Complaint, the Ninth Circuit affirmed the district court's decision to take judicial notice of the $120 million judgment obtained by Stac against Microsoft Corporation for patent

infringement and found on that basis that Stac's statements that its product was protected by patent were not false and misleading. (Pet. App. at 14a).

The Ninth Circuit then determined, based on its review of the Prospectus, that Stac made adequate disclosure of the threat that Microsoft might include data compression functionality in its new operating system, MS-DOS 6.0. *Id.* at 14a-17a. To the extent that the Prospectus did not definitively predict such competition from Microsoft, the Ninth Circuit held that Stac was under no duty to predict the future and that Stac could not know with certainty the product plans of its competitors – particularly when the threatened new product would violate Stac's own patents. *Id.* at 15a-17a. Finally, the Ninth Circuit noted in this regard that plaintiffs themselves alleged that public demand for Stac's product was declining because the public believed that Microsoft might include data compression in its new operating system. *Id.* at 24a. In light of this judicial admission, buttressed by the recognized legal conclusion that the public is aware of the risk of obsolescence in the high technology industry, plaintiffs could not prevail in their fraud on the market claim.

With respect to the allegations of financial improprieties, the Ninth Circuit found that "the Prospectus describes the phenomenon of channel-filling with its attendant risks, spells out Stac's liberal return policy, warns investors of Stac's exposure to the risk of product returns, and advises investors not to predict future returns on the basis on the results of any single quarter." *Id.* at 17a. The Ninth Circuit then found not only that these disclosures negated plaintiff's allegations of factual omissions but also "bespoke caution" thus leading "to the

inexorable conclusion that investors were specifically and adequately cautioned about the relevant risks. Insofar as Stac's alleged misstatements can be viewed as 'optimistic projections,' they are more than adequately covered by the bespeaks caution doctrine." *Id.* at 21a-22a. The Ninth Circuit found that "the Stac prospectus neither stints on warnings nor fails to disclose Stac's practices, but 'fairly overflows' with specific and detailed cautionary language." *Id.* at 23a.

Finally, the Ninth Circuit found that Fed. R. Civ. P. 9(b) applies to claims brought under Section 11 of the Securities Exchange Act when such claims "are grounded in fraud." *Id.* at 11a. The Ninth Circuit employed Rule 9(b) as an alternative basis for dismissal of claims based on the Prospectus and dismissed allegations relating to Stac's road show presentations for failure to plead fraud with sufficient particularity. *Id.* at 22a-23a, 26a. It also dismissed the claim against the one remaining newly-named defendant, John Witzel, under the statute of limitations. Petitioners do not challenge the Ninth Circuit's ruling on the statute of limitations.

ARGUMENT

I. BECAUSE THE PRESENT CASE WAS DECIDED UNDER PLEADING STANDARDS DRAMATICALLY ALTERED BY THE PRIVATE SECURITIES LITIGATION REFORM ACT, THIS CASE DOES NOT MERIT THIS COURT'S ATTENTION

In December 1995, Congress passed the Private Securities Litigation Reform Act of 1995 (the "Reform Act"),

Pub. Law No. 104-67. The Reform Act dramatically changed the law governing the requirements for pleading a claim for securities fraud. Among other things, it heightened the requirements for pleading *scienter*, provided safe harbors for certain forward-looking statements, and made explicit the particularity requirements for securities fraud claims. The Reform Act defines the pleading standards for all securities fraud claim actions filed after December 23, 1995.

This case was filed in 1992, well before enactment of the Reform Act. Each court to have addressed the merits of the complaint did so under the law in effect prior to enactment of the Reform Act. None of the courts addressing the complaint considered any of the provisions of the Reform Act in reaching their conclusions.

Because this case involves the application of pleading standards largely superseded by the Reform Act, any decision rendered by the Court would have little effect on subsequent cases or the development of securities law in general. Accordingly, none of the issues raised by the present case present "important federal questions" within the meaning of United States Supreme Court Rule 10. To accept certiorari in this case would be to render a decision on legal issues rendered largely moot by Congressional enactment of the Reform Act and would constitute a waste of this Court's scarce resources.

II. THE NINTH CIRCUIT'S RULING THAT FED. R. CIV. P. 9(B) APPLIES TO CLAIMS ASSERTED UNDER SECTION 11 OF THE EXCHANGE ACT IS CONSISTENT WITH THE DECISION OF EVERY OTHER CIRCUIT COURT, IS CORRECT, AND IS NOT, IN ANY EVENT, OUTCOME DETERMINATIVE

The Ninth Circuit held in this case that "the particularity requirements of Rule 9(b) apply to claims brought under Section 11 when, as here, they are grounded in fraud." Pet. App. at 11a. This ruling is consistent with the ruling of every other Circuit Court to have addressed the issue. *Shaw v. Digital Equipment Corp.*, 82 F.3d 1194, 1223 (1st Cir. 1996); *Melder v. Morris*, 27 F.3d 1097, 1100 n.6 (5th Cir. 1994); *Shapiro v. UJB Fin. Corp.*, 964 F.2d 272, 287-89 (3d Cir.), *cert. denied*, 506 U.S. 934 (1992). Petitioners have identified, and research has disclosed, no Circuit Court to have taken a contrary view. The only conflict among "the lower courts" to which Petitioners can therefore cite is the conflict between older district court decisions and the more recent decisions of the Courts of Appeals. *See* Petition at 10-11 & nn. 4 & 5. There is not, therefore, any decision "in conflict with the decision of another United States court of appeals on the same important matter." S. Ct. Rule 10(a).

The Ninth Circuit's ruling on the applicability of Rule 9(b) was, in any event, correct. The application of Rule 9(b) does not depend upon the elements of the claims asserted; it depends instead on whether the cause of action includes "averments of fraud." *See Shapiro v. UJB Fin. Corp.*, 964 F.2d at 287-89. Put another way, while

a Section 11 claim does not require an allegation of fraudulent intent, if plaintiff chooses nevertheless to include an allegation of fraudulent intent, such an allegation must be pleaded with the particularity required by Rule 9(b). Nothing in Section 11 of the Securities Act prohibits the application of Rule 9(b) to allegations that the plaintiff chooses to frame in terms of fraud. In this case, the Ninth Circuit found that the Section 11 claims were "grounded in fraud." This finding was based on plaintiffs' allegation in their Section 11 claim incorporating all 75 of the preceding paragraphs of the complaint, including allegations that defendants acted intentionally and fraudulently.[4] The Ninth Circuit's application of the legal principle that Rule 9(b) applies to allegations of fraud does not merit this Court's attention.

These holdings are not inconsistent with this Court's decision in *Leatherman v. Tarrant County Narcotics Intelligence & Coordination Unit*, 507 U.S. 163 (1993). There, the Court determined that policy considerations could not justify the imposition of heightened pleading standards for § 1983 claims against municipalities that were not based on fraud. There was no allegation of fraud in the complaint at issue in *Leatherman*. By contrast, here and in the other Circuit Court decisions applying Rule 9(b) to Section 11 claims, plaintiffs alleged fraud – which falls directly within the ambit of Rule 9(b).

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[4] While it is true that in incorporating the prior 75 paragraphs, plaintiffs attempted to "except allegations of fraud," the Ninth Circuit found "[t]hese nominal efforts unconvincing where the gravamen of the complaint is plainly fraud." Pet. App. at 11a. Indeed, the complaint nowhere alleges any basis for Section 11 liability other than fraud.

Even if not correct, the Ninth Circuit's application of Rule 9(b) was not outcome determinative. The Ninth Circuit disposed of all of petitioners' claims based on the Prospectus by determining either that the allegedly omitted facts were disclosed, need not have been disclosed, or were adequately covered by the bespeaks caution doctrine. At most, the Ninth Circuit employed Rule 9(b) as an alternative ground for dismissal of plaintiffs' Section 11 claims based on the Prospectus. Pet. App. at 22a-23a.

The only claims dismissed on the sole basis of Rule 9(b) were claims based on alleged oral statements purportedly made by defendants during pre-offering "road show" presentations to investors and securities analysts. Pet. App. at 26a. By definition, these were Section 10(b) and Rule 10b-5 claims, not Section 11 claims. Section 11 provides a claim for relief only "[i]n case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading." 15 U.S.C. § 77k. Since the claims dismissed under Rule 9(b) were not based on statements in the registration statement but were instead oral statements made in road shows, the claims by definition were asserted under Section 10(b) of the Exchange Act. Even Petitioners admit that there is no dispute as to the applicability of Rule 9(b) to claims asserted under Section 10(b) and Rule 10b-5, each of which required pleading and proof of *scienter.*

III. THE NINTH CIRCUIT'S DISMISSAL OF CLAIMS BASED ON ITS DETERMINATION THAT THE ALLEGEDLY OMITTED FACTS WERE ACTUALLY DISCLOSED IN DOCUMENTS UPON WHICH PLAINTIFFS BASED THEIR CLAIMS PRESENTS NO IMPORTANT QUESTION OF LAW

In affirming dismissal of the Second Amended Complaint, the Ninth Circuit reviewed the public documents cited in the complaint and determined that those documents actually disclosed the very facts that plaintiffs alleged were concealed. This determination presents no important question of law; it was, instead, an application of a properly stated rule of law.

It is elemental that in order to be actionable under the federal securities laws, a Prospectus must "omit[ ] to state a material fact . . . necessary to make the statements therein not misleading." 15 U.S.C. § 77k. Likewise, in order to be actionable under Section 10(b) and Rule 10b-5, a statement must "omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they are made, not misleading." 17 C.F.R. 240.10b-5. Applying this established standard of liability, the Circuit Courts that have addressed the issue are unanimous that where the allegedly omitted fact is actually disclosed, plaintiff cannot state a claim. *Romani v. Shearson Lehman Hutton*, 929 F.2d 875 (1st Cir. 1991); *In re Donald J. Trump Casino Sec. Litig.*, 7 F.3d 357 (3d Cir. 1993), *cert. denied*, 510 U.S. 1178 (1994); *Nobles v. First Carolina Communications, Inc.*, 929 F.2d 141 (4th Cir. 1991); *In re Convergent Technologies Sec. Litig.*, 948 F.2d 507, 515-16 (9th Cir. 1991).

There is no conflict among the Circuit Courts regarding this statement of the law. The most that Petitioners may argue is that the Ninth Circuit misapplied this rule of law. No such misapplication occurred. In this case, as the Ninth Circuit found, the Prospectus expressly disclosed the threat that Microsoft might enter the data compression market, that the Company's reserves for product returns may not be adequate, and that demand for Stac's product might decline in the wake of recent channel fill. The Ninth Circuit's application of settled law to the allegations of the complaint, including the Prospectus, is not the proper basis for a grant of certiorari.

Nor is there any dispute among the Circuit Courts that the determination of whether a challenged statement actually disclosed allegedly omitted facts may be made on a motion to dismiss where the documents containing the disclosures are cited and quoted in the complaint. *San Leandro Emergency Medical Group Profit Sharing Plan v. Philip Morris Companies, Inc.*, 75 F.3d 801 (2d Cir. 1996); *In re Donald J. Trump Casino Sec. Litig.*, 7 F.3d 357 (3rd Cir. 1993), *cert. denied*, 510 U.S. 1178 (1994); *Nobles v. First Carolina Communications, Inc.*, 929 F.2d 141 (4th Cir. 1991); *Lovelace v. Software Spectrum, Inc.*, 78 F.3d 1015 (5th Cir. 1996); *Branch v. Tunnell*, 14 F.3d 449 (9th Cir.), *cert. denied*, 114 S. Ct. 2704 (1994); *Durning v. First Boston Corp.*, 815 F.2d 1265 (9th Cir.), *cert. denied*, 484 U.S. 944 (1987).

Accordingly, the Ninth Circuit's decision is in accord with the legal interpretation and procedural practices of every Circuit Court to have addressed the issue. It presents no conflict among the Courts of Appeal and no important question of law that requires resolution by this Court.

IV. THE NINTH CIRCUIT'S APPLICATION OF THE BESPEAKS CAUTION DOCTRINE PRESENTS NO IMPORTANT QUESTION OF LAW WORTHY OF THIS COURT'S ATTENTION

Every Circuit Court to have addressed the issue has held that the bespeaks caution doctrine applies to claims under the federal securities laws. *See, e.g., Shaw v. Digital Equipment Corp.*, 82 F.3d 1194 (1st Cir. 1996); *Romani v. Shearson Lehman Hutton*, 929 F.2d 875, 879 (1st Cir. 1991); *San Leandro Emerg. Med. Group Profit Sharing Plan v. Philip Morris Cos.*, 75 F.3d 801, 811 (2d Cir. 1996); *I. Meyer Pincus & Assocs., P.C. v. Oppenheimer & Co.*, 936 F.2d 759, 763 (2d Cir. 1991); *In re Donald J. Trump Casino Sec. Litig.*, 7 F.3d 357, 371 (3d Cir. 1993), *cert. denied*, 510 U.S. 1178 (1994); *Rubinstein v. Collins*, 20 F.3d 160, 166-68 (5th Cir. 1994); *Sinay v. Lamson & Sessions Co.*, 948 F.2d 1037, 1040 (6th Cir. 1991); *Harden v. Raffensperger, Hughes & Co.*, 65 F.3d 1392, 1404 (7th Cir. 1995); *Saltzberg v. TM Sterling/Austin Associates, Ltd.*, 45 F.3d 399, 400 (11th Cir. 1995). That doctrine "provides a mechanism by which a court can rule as a matter of law that defendants' forward-looking representations contained enough cautionary language or risk disclosure to protect the defendant against claims of securities fraud." *Fecht v. Price Company*, 70 F.3d 1078, 1081 (9th Cir. 1995), *cert. denied*, 116 S. Ct. 1422 (1996) (citation omitted). It "merely represents the pragmatic application of two fundamental concepts in the law of securities fraud: materiality and reliance." *In re Worlds of Wonder Sec. Litig.*, 35 F.3d 1407, 1414 (9th Cir. 1994), *cert. denied*, 116 S. Ct. 185 (1995).

In enacting the Reform Act, Congress specifically endorsed and encouraged further judicial development of the bespeaks caution doctrine. Thus, the "safe harbor" provisions of the Reform Act are based in part on the judicially created bespeaks caution doctrine, and Congress took special pains to note that it "does not intend for the safe harbor provisions to replace the judicial 'bespeaks caution' doctrine or to foreclose further development of that doctrine by the courts." H.R. Conf. Rep. No. 104-369, 104th Cong., 1st Sess. at 46 (1995). Given this Congressional endorsement of the doctrine, there can be no question but that the doctrine should continue to apply to securities fraud claims.

Accordingly, the only questions even arguably raised by the Ninth Circuit's decision in this case is whether its *application* of the doctrine was correct. The question of applicability of a settled rule of law to the particular complaint at issue here is not an important question of law worthy of the Court's attention.

CONCLUSION

For all of the reasons set forth above, Respondents respectfully request that this Court deny the Petition for Writ of Certiorari in this case.

Dated: January 31, 1997

Respectfully submitted,

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No. 96-845

In The

Supreme Court of the United States

October Term, 1996

TIMOTHY J. ANDERSON, NEIL SINGER and ARTHUR SINGER, On Behalf of Themselves and All Others Similarly Situated,

Petitioners,

vs.

GARY W. CLOW, DOUGLAS L. WHITING, ROBERT W. JOHNSON, ARTHUR J. COLLMEYER, JOHN R. WITZIL, STAC ELECTRONICS, INC., ALEX. BROWN & SONS, INC. and MONTGOMERY SECURITIES,

Respondents.

On Petition For Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

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I. INTRODUCTION

None of Respondents' reasons for denying the Petition for Certiorari withstands scrutiny.

Respondents say that the law applied by the Ninth Circuit in this case has been superseded by the Private Securities Exchange Act of 1995 ("PSLRA"). This is not true. Respondents contend that the PSLRA "heightened the requirements for pleading *scienter*, provided safe harbors for certain forward-looking statements, and made explicit the particularity requirements for securities fraud claims." Stac Opp. at 11. But *scienter* is not relevant to the Securities Act §11 claims at issue in this case, *see Herman & MacLean v. Huddleston*, 459 U.S. 375, 381-82 (1983), and the PSLRA's particularity requirements for securities-fraud claims apply, by their terms, only to fraud-based Securities Exchange Act claims, not to Securities Act claims. *See* 15 U.S.C. §78u-4(b). Respondents *concede* that the PSLRA's safe harbor for forward-looking statements does not supersede the conflicting bespeaks-caution case law. *See* Stac Opp. at 18. Thus, the PSLRA does not supersede *any* issue raised by the Petition for Certiorari.

Respondents nonetheless contend that the proper pleading burdens for §11 claims are immaterial, because the Ninth Circuit dismissed plaintiffs' claims under the bespeaks-caution doctrine. But a court should have no occasion to apply bespeaks-caution analysis unless Rule 9(b) requires falsity to be pleaded with particularity in a

§11 complaint. In addition, the Ninth Circuit's bespeaks-caution holding itself warrants review – and reversal.

Respondents say the petition identifies no conflict of consequence, but subjecting §11 claimants to heightened pleading standards conflicts with this Court's holdings that §11 claimants cannot be required to plead or prove fraud, *Huddleston*, 459 U.S. at 381-83, and that nonfraud claims cannot be subjected to heightened pleading requirements. *Leatherman v. Tarrant County Narcotics Intelligence & Coordination Unit*, 507 U.S. 163, 167-68 (1993). The notion that Rule 9(b) protects defendants who violate §11 *with intent to defraud*, because plaintiffs' claims then "sound in fraud," is ludicrous. Section 11 places the burden of pleading and proving good faith and due diligence on defendants, not plaintiffs. 15 U.S.C. §77k(b)(3); *Huddleston*, 459 U.S. at 382.

Finally, Respondents cannot paper over the conflicts among the circuits' bespeaks-caution precedents.

The questions presented are very important – going to the heart of what must be pleaded to state Securities Act claims. Decisional law in the lower courts is extensive and confused, the issues are not resolved by the PSLRA, and the time is ripe for this Court to resolve the conflicts in that law.

II. ARGUMENT

A. The Private Securities Litigation Reform Act Of 1995 Neither Supersedes Nor Eliminates Conflicts In Existing Law On The Questions Presented

The PSLRA does nothing to "supersede" the issues presented by the Petition for Certiorari. If anything, enactment of the PSLRA heightens the importance of the questions presented.

The PSLRA's codification of particularized-pleading requirements for fraud-based Exchange Act claims does not affect the principle that particularized pleading cannot be required for strict-liability Securities Act claims. While the PSLRA requires particularized pleading of *fraud* claims *under the Exchange Act*, 15 U.S.C. §78u-4(b), it says nothing about particularity for pleading strict-liability *Securities Act* claims. *Compare* 15 U.S.C. §77z-1(b) *with* 15 U.S.C. §78u-4(b).

The PSLRA's "safe harbor" for forward-looking statements, 15 U.S.C. §78u-5(c), neither applies to a prospectus for an initial public offering, 15 U.S.C. §78u-5(b)(2)(D), nor supersedes existing bespeaks-caution case law – as Respondents themselves admit. *See* Stac Opp. at 18. Congress "[did] not intend for the safe harbor provisions to replace the judicial 'bespeaks caution' doctrine or to foreclose further development of that doctrine by the courts." H.R. Conf. Rep. No. 104-369, 104th Cong., 1st Sess. at 46, *reprinted in* 1995 U.S.C.C.A.N. 730, 745. Stac concedes that given the PSLRA's recent "Congressional endorsement of the doctrine, there can be no question but that the doctrine should continue to apply to securities fraud claims."

Stac Opp. at 18. This disposes of any contention that the PSLRA somehow "supersedes" conflicting bespeaks-caution precedents.

B. Pleading Standards For Section 11 Claims Warrant This Court's Review

Respondents try to trivialize the issue of what pleading standards should govern plaintiffs' §11 claims, arguing that appropriate pleading standards are immaterial because the Ninth Circuit found that any misstatements are not actionable under the bespeaks-caution doctrine. This makes no sense.

Under Ninth Circuit law, *Rule 9(b)* requires plaintiffs to plead evidentiary facts raising an inference of falsity.[1] Obviously, if Rule 9(b) does not apply plaintiffs are not required to demonstrate falsity in the complaint.[2] If falsity need not be shown in the complaint, however, a court has no occasion – or right – to make a bespeaks-caution inquiry in order to determine, at the pleading stage, whether or not defendants' statements were actionably misleading. Simply put, the Ninth Circuit could not properly rely on the bespeaks-caution doctrine to dismiss Petitioners' §11 claims at the pleading stage unless Rule 9(b) applied to them. Thus, its bespeaks-caution holding only magnifies the importance of determining whether

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[1] *See Warshaw v. Xoma Corp.*, 74 F.3d 955, 960 (9th Cir. 1996); *Fecht v. Price Co.*, 70 F.3d 1078, 1082 (9th Cir. 1995), *cert. denied*, ___ U.S. ___, 116 S. Ct. 1422 (1996); *In re Glenfed, Inc. Sec. Litig.*, 42 F.3d 1541, 1547-49 (9th Cir. 1994) (en banc).

[2] *See Scheuer v. Rhodes*, 416 U.S. 232, 236 (1974); *Conley v. Gibson*, 355 U.S. 41, 45-46 (1957).

Rule 9(b) fraud pleading standards apply to strict-liability §11 claims.

Brushing aside conflict among the district court decisions, Respondents say there is no inter-circuit conflict. Respondents thus ask this Court to ignore the conflict of the decision below (and other cases) with its own holdings that §11 claims *are not claims for fraud*, *Huddleston*, 459 U.S. at 381-82, and that heightened pleading requirements cannot be extended beyond the narrow scope of Rule 9(b)'s text – which allows courts to require particularity only in averments of fraud or mistake. *Leatherman*, 507 U.S. at 167-68.

Respondents also hope this Court will ignore the conceptual incoherence of decisions holding that although neither fraud nor negligence is an element under §11, plaintiffs nonetheless must plead one or the other with particularity.[3] This frustrates a legislative scheme that places *on defendants* the burden of pleading and proving that they acted in good faith and with due diligence – *as an affirmative defense*. *See* 15 U.S.C. §77k(b)(3); *Huddleston*, 459 U.S. at 382; Louis Loss & Joel Seligman, *Fundamentals of Securities Regulation* 1005-06 (3d ed. 1995). Plaintiffs cannot be required to plead on the subject of an affirmative defense. *Gomez v. Toledo*, 446 U.S. 635, 640 (1980).

According to Respondents, although §11 imposes strict liability for a misleading registration statement, they are entitled to avoid liability under Rule 9(b) in this

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[3] *See, e.g., Shapiro v. UJB Financial Corp.*, 964 F.2d 272, 287-88 (3d Cir. 1992) (applying Rule 9(b) because complaint lacked "allegations that defendants were negligent in violating, §§11 and 12"); *compare* 11a n.2; 41a n.3.

case if the facts alleged suggest that they acted with fraudulent intent – because any suggestion of scienter makes the claims "sound in fraud." This is wrong: "Even where a plaintiff's complaint improperly contains allegations that seek to avoid or defeat a potential affirmative defense, 'it is inappropriate for the court to shift the burden of proof on the anticipated defense to plaintiff as a "sanction" for failing to follow the burden of pleading structure established by Rule 8 or by adopting the fiction that plaintiff's anticipation of the issue evidences his intention to "assume" the burden of proving it.' "[4]

The notion that Rule 9(b) provides protection to defendants who violate §11 *with intent to defraud* because plaintiffs' claims then "sound in fraud," turns logic on its head and perverts the fundamental framework of the Securities Act. That act places the burden of pleading and proving good faith and due diligence on defendants, not plaintiffs. 15 U.S.C. §77k(b)(3). Congress believed that "[t]he provisions throwing upon the defendant in suits under sections 11 and 12 the burden of proof to exempt himself are indispensable to make the buyer's remedies under these sections practically effective," for "[e]very lawyer knows that with all the facts in the control of the defendant it is practically impossible for a buyer to prove a state of knowledge or a failure to exercise due care on the part of defendant." H.R. Rep. No. 85, 73d Cong., 1st Sess. at 9 (1933).

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[4] *Vance v. Terrazas*, 444 U.S. 252, 269 n.11 (1980) (quoting 5 Charles Alan Wright & Arthur R. Miller, *Federal Practice And Procedure* §1276, at 327 (1969); *see* 5A Charles Alan Wright & Arthur R. Miller, *Federal Practice And Procedure: Civil 2d* §1276, at 460-61 (2d ed. 1990).

The Ninth Circuit has reversed the statutory burdens of pleading and proof, by holding that plaintiffs in this case must plead *fraud* with particularity to proceed with their §11 claims, and the issue is ripe for this Court's review.

C. The Bespeaks-Caution Doctrine Is Ripe For This Court's Review

The time also is ripe for this Court to consider the so-called bespeaks-caution doctrine, which has been developed and applied by many lower federal courts to provide " 'a mechanism by which a court can rule as a matter of law that defendants' forward-looking representations contained enough cautionary language or risk disclosure to protect the defendant against claims of securities fraud.' " 19a-20a (quoting *Fecht v. Price Co.*, 70 F.3d 1078, 1081 (9th Cir. 1995), *cert. denied*, ___ U.S. ___, 116 S. Ct. 1422 (1996)).

Conflicts in the bespeaks-caution case law run deep. Confusion about the controlling law is evident even in Respondents' briefs – which blithely cite an overruled Sixth Circuit decision, *Sinay v. Lamson & Sessions Co.*, 948 F.2d 1037 (6th Cir. 1991), as an example of the many bespeaks-caution circuit court decisions that supposedly all apply "substantially the same rule." Alex. Brown Opp. at 20; *see* Stac Opp. at 17. In fact, the Sixth Circuit itself held in *Mayer v. Mylod*, 988 F.2d 635, 638-40 (6th Cir. 1993), that *Sinay* conflicts with this Court's holding in *Virginia Bankshares v. Sandberg*, 501 U.S. 1083, 1096-98 (1991), and that cautionary boilerplate is no automatic bar to liability under the federal securities laws.

Some courts, ignoring *Virginia Bankshares*, readily apply the bespeaks-caution doctrine at the pleading

stage, dismissing many claims as a matter of law. *See* Stac Opp. at 16. Others, like the Seventh Circuit, frown on its application at the pleading stage, *Roots Partnership v. Lands' End, Inc.*, 965 F.2d 1411, 1417 n.5 (7th Cir. 1992), and "have yet to encounter a case where the doctrine applied to negate the materiality of a misleading statement as a matter of law," at *any* stage of litigation. *United States v. Morris*, 80 F.3d 1151, 1167 (7th Cir.), *cert. denied*, ___ U.S. ___, 117 S. Ct. 181 (1996).

Disputes regarding the character and scope of the bespeaks-caution doctrine obviously involve more than "case-by-case" differences in application of settled law. Some decisions – including the one below – hold that disclaimers that there can be "no assurance" that representations will prove accurate eliminate liability as a matter of law.[5] Others hold that indistinguishable "no assurance" disclaimers cannot eliminate liability as a matter of law.[6] In many instances courts have held that warnings and disclosures far more extensive than those at issue in this case do not avoid liability as a matter of law.[7] The First Circuit has held that the doctrine does not apply

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[5] *E.g., Olkey v. Hyperion 1999 Term Trust*, 98 F.3d 2, 6-7 (2d Cir. 1996) (relying on "no assurance" disclaimer to dismiss complaint over Chief Judge Newman's dissent).

[6] *E.g., Morris*, 80 F.3d at 1166-68; *Harden v. Raffensperger Hughes & Co.*, 65 F.3d 1392, 1404-06 (7th Cir. 1995); *Rubinstein v. Collins*, 20 F.3d 160, 163-64, 166-68 (5th Cir. 1994).

[7] *See, e.g., In re Westinghouse Sec. Litig.*, 90 F.3d 696, 708-10 (3d Cir. 1996); *Shaw v. Digital Equip. Corp.*, 82 F.3d 1194, 1213-14 (1st Cir. 1996).

when plaintiffs contend historical financial results are misleading,[8] but the Ninth Circuit applied the doctrine to overstated historical financial results in this case.

To put it bluntly, this body of law is incoherent, and it is time for this Court to intervene and restore order.

III. CONCLUSION

For the foregoing reasons, the Petition for a Writ of Certiorari should be granted.

DATED: February 11, 1997

Respectfully submitted,

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[8] *Shaw*, 82 F.3d at 1213.

No. 96-845

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In The

Supreme Court of the United States

October Term, 1996

TIMOTHY J. ANDERSON, NEIL SINGER and ARTHUR SINGER, On Behalf Of Themselves And All Others Similarly Situated,

Petitioners,

v.

GARY W. CLOW, DOUGLAS L. WHITING, ROBERT W. JOHNSON, ARTHUR J. COLLMEYER, JOHN R. WITZIL, STAC ELECTRONICS, INC., ALEX. BROWN & SONS, INC., and MONTGOMERY SECURITIES,

Respondents.

On Petition For Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

BRIEF OF ALEX. BROWN & SONS INCORPORATED AND MONTGOMERY SECURITIES IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED

Should the Court review either the court of appeals' holding that (1) Rule 9(b)'s requirement that "in *all* averments of fraud" the circumstances must be stated with particularity applies to a Section 11 claim that "sounds in fraud," or that (2) the prospectus *in this case* "include[d] enough cautionary language or risk disclosure that reasonable minds could not disagree that the challenged statements were not misleading" where neither holding:

- conflicts with a decision of any other court of appeals or of this Court; or
- has any significance beyond the parties, or made any difference to the outcome of this case because, as the court of appeals found, either the prospectus disclosed the very information petitioners claimed was not disclosed or defendants had no obligation to disclose it in the first place?

LIST OF RELATED ENTITIES PURSUANT TO SUPREME COURT RULE 29.6

Pursuant to Supreme Court Rule 29.6, the following information is provided by Alex. Brown & Sons Incorporated and Montgomery Securities.

Alex. Brown & Sons Incorporated is owned by Alex. Brown Incorporated, which has issued shares to the public. Alex. Brown & Sons Incorporated has no subsidiary or affiliate that has issued shares to the public.

Montgomery Securities is not a corporation.

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INTRODUCTION

This is yet another securities class action against a high-tech start-up company based on price fluctuations, not on conduct prohibited by the securities laws. The initial complaint was filed just *two* days after the company's stock price fell. Despite a comprehensive prospectus addressing material risks, the complaint alleged an elaborate scheme to defraud investors perpetrated by virtually everyone involved in bringing the company public. In reality, though, it simply sought a form of insurance against the normal risks of investing in high-tech stocks. The potential for abuse in cases of this type is well recognized, and their economic toll has prompted Congress to heighten substantially the pleading requirements under the federal securities laws to protect companies entering the capital markets. It is therefore vital that the federal courts carefully scrutinize allegations that the securities laws have been violated to ensure that reasonable pleading requirements have been satisfied.

That is all that occurred in this case. Four federal judges carefully examined the allegations in the operative complaint. All four found that the complaint failed to allege a material misrepresentation or omission in the Prospectus under either Section 11 of the Securities Act of 1933 or Section 10(b) of the Exchange Act of 1934. All four found that the Prospectus amply disclosed the allegedly omitted information, and that the complaint failed to allege fraud under Section 10(b) with the particularity required by Federal Rule of Civil Procedure 9(b). In addition, the Ninth Circuit joined every other court of appeals to address the issue and held that because the Section 11 claim "sounded in fraud," it too was subject to Rule 9(b).

Accordingly, the Ninth Circuit affirmed dismissal of the complaint with prejudice.

There is no basis for this Court's review. Contrary to Petitioners' misleading suggestion, there is no conflict among the circuits or with this Court's decision in *Leatherman v. Tarrant County Narcotics Intelligence & Coordination Unit*, 507 U.S. 163 (1993), regarding the application of Rule 9(b) to Section 11 claims sounding in fraud. Five circuits have considered the issue, and all unanimously hold that, although fraud need not be pleaded to state a claim under Section 11, if the basis of the claim *is* fraud, the particularity requirements of Rule 9(b) apply. Nor is there any conflict with *Leatherman*, which simply limited Rule 9(b) to averments of fraud or mistake. Where, as here, averments of fraud permeate a Section 11 claim, Rule 9(b) applies by its plain terms, consistent with *Leatherman*. Thus, Petitioners' first "Question" – "can [Rule 9(b)] be applied to claims under Section 11" – raises no controversy worthy of this Court's time and attention.

Nor does it present an important legal issue. The Ninth Circuit's Rule 9(b) holding was not essential to its decision; the Section 11 claims fail even without Rule 9(b). As both courts observed, the Prospectus "fairly overflow[ed]" with "specific and detailed" warnings on the very points that Petitioners allege defendants failed to disclose. Accordingly, Petitioners simply failed to allege a material misrepresentation in the Prospectus, as Section 11 requires. Because that conclusion turns on the unique allegations in this case, and not solely on the application of Rule 9(b), the Ninth Circuit's decision has no widespread application, and presents no legal issue deserving review by this Court.

Nor is Petitioners' second "Question" – whether plaintiffs can plead Section 11 and Section 10(b) claims in the same complaint, without subjecting their Section 11 claims to the heightened pleading requirements for fraud claims – presented here. Nothing in the Ninth Circuit's opinion precludes plaintiffs from pleading both claims together. Rule 9(b) applied to Petitioners' Section 11 claim, not because they pleaded their Section 11 and Section 10(b) claims in the same complaint, but because the basis alleged for their Section 11 claim was fraud. Accordingly, the court logically found that Rule 9(b), which applies to "*all* averments of fraud," should apply to these claims as well.

Petitioners' final "Question" – do "no assurance" disclaimers in a prospectus "immunize" defendants against false statements under the "bespeaks caution" doctrine as a matter of law – has no place here either. The Ninth Circuit did not hold that such disclaimers are necessarily dispositive of defendants' liability. To the contrary, it held only that the multitude of specific warnings and risk disclosures in *this* prospectus, including (rather than solely because of) these disclaimers, adequately informed investors of the matters that were allegedly undisclosed. Thus, Petitioners' quarrel is not with the Ninth Circuit's *articulation* of the bespeaks caution doctrine, which has been adopted by nearly every Circuit, but only with its *application* of that settled principle to the facts here. That decision, correct or not, does not require this Court's review.

Accordingly, the petition should be denied.

STATEMENT OF THE CASE

This action arises out of the May 1992 initial public offering ("IPO") of 3 million shares of common stock by Stac Electronics, Inc. ("Stac"), a developer of data compression products for computers. On July 20, 1992, Stac announced lower-than-expected third quarter results, and the market price of its stock declined. Just two days after Stac's announcement, Petitioners, disappointed investors, sued Stac, its officers and directors (the "Stac defendants") and lead underwriters Alex. Brown & Sons Incorporated and Montgomery Securities (the "Underwriters"). They alleged that the IPO violated Section 11 of the Securities Act of 1933, 15 U.S.C. § 77k ("Section 11"), and Section 10(b) of the Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10(b)(5) (collectively, "Section 10(b)"). App. 184a, 243a-251a.

Petitioners' Second Amended Complaint (the "Complaint"),[1] the subject of this petition, charged that defendants schemed to defraud investors by disseminating false and misleading information in a prospectus

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[1] Petitioners' Consolidated Amended Class Action Complaint ("First Amended Complaint"), filed on December 4, 1992, made substantially similar allegations, and was dismissed without prejudice by the district court on September 30, 1993. *See gen'ly Anderson v. Clow*, [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,807 (S.D. Cal. 1993), App. 113a-152a. Among other things, Petitioners had explicitly alleged that the Prospectus was "fraudulent" and had based their Section 11 claim on the same facts as their Section 10(b) claim. *Id.* at 97,990, App. 134a-135a.

issued in May 1992 in connection with the IPO (the "Prospectus"). App. 173a. In particular, the Prospectus allegedly failed to disclose that Stac's business was entering a period of protracted decline; that competition from Microsoft was imminent; that Stac purposely stalled licensing negotiations with Microsoft to delay its entrance into the market until after the IPO; that the patents on Stac's products were inadequate; and that Stac had offered its customers special terms and discounts that artificially inflated Stac's reported results for the quarter preceding the IPO. *See, e.g.*, App. 211a-212a, 215a, 216a-217a. The scheme was purportedly intended to artificially buoy the value of Stac's stock for the Stac defendants' personal profit and to ensure the success of the IPO. App. 172a-173a, 199a-200a, 218a-219a. The Underwriters allegedly participated in the scheme to earn over $2.5 million in underwriting fees from the IPO. App. 190a-191a.

The Underwriters and the Stac defendants each moved to dismiss the Complaint for failure to state a claim under Rule 12(b)(6), and for failure to plead fraud with particularity under Rule 9(b). The district court granted defendants' motions. Because this was Petitioners' third attempt to state a claim, and because Petitioners had had fourteen months in which to conduct discovery and correct the deficiencies in the Complaint, the district court dismissed it with prejudice.[2] *Anderson v.*

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[2] The court held that the Section 11 claims failed because the Prospectus disclosed the allegedly omitted facts in ways that rendered the Prospectus's statements not misleading, or because defendants were not required to disclose the purported

Clow, [1994-95 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,367 at 90,525, 90,528 (S.D. Cal. 1994), App. 103a, 111a.

A unanimous Ninth Circuit affirmed, principally on two independent grounds. First, Petitioners' Section 11 and Section 10(b) claims both failed to state a claim under Rule 12(b)(6) because the Prospectus adequately disclosed the information Petitioners claimed was not disclosed. The court found that the Prospectus "fairly overflow[ed]" with "specific and detailed cautionary language" and risk disclosures. *In re Stac Electronics Sec. Litig.*, 89 F.3d 1399, 1409 (9th Cir. 1996), App. 23a. In particular, the Prospectus described in detail the phenomenon and risk of "channel fill," spelled out Stac's liberal return policy, and warned investors of the risk of product returns. *Id.* at 1407-08, App. 17a-19a. Accordingly, to the extent any of the alleged misstatements were forward-looking, such as those concerning the adequacy of Stac's reserves and the risk of product returns, the Complaint failed under the Circuit's "bespeaks caution" doctrine since "investors were specifically and adequately cautioned about the relevant risks." *Id.* at 1409, App. 22a.

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omissions. *Anderson v. Clow*, [1994-95 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 90,521, App. 88a-89a. The Section 10(b) claims failed for the same reason, and because the Complaint failed to allege fraud with particularity. *Id.* at 90,524-90,525, App. 97a-101a. The District Court did *not* apply the particularity requirements of Rule 9(b) to Petitioners' Section 11 claims. *See id.* at 90,516-90,521, App. 70a-87a; *see also In re Stac Electronics Sec. Litig.*, 89 F.3d 1399, 1403 (9th Cir. 1996), App. 8a. Nor did it rely on the "bespeaks caution" doctrine.

Moreover, to the extent the allegedly concealed information was historical in nature (to which the "bespeaks caution" doctrine did not apply), it too was adequately disclosed in the Prospectus. *Id.*, App. 23a.

The court also held that, whether or not the disclosures in the Prospectus were adequate, Petitioners' Section 11 and Section 10(b) claims failed to comply with the particularity requirements of Rule 9(b). *In re Stac Electronics Sec. Litig.*, 89 F.3d at 1409, App. 22a-23a. Specifically, Petitioners failed to state what was false and misleading about the statements in the Prospectus and why they were false. *Id.* The court reasoned that Rule 9(b) was applicable to Petitioners' Section 11 claims because the "gravamen of the [Complaint was] plainly fraud and no effort [was] made to show any other basis for the claims levied at the Prospectus." *Id.* at 1405 n.2, App. 11a n.2. Accordingly, the claim was "grounded in fraud," *id.* at 1404-05, App. 11a, and properly subject to the heightened pleading standards and protections afforded by Rule 9(b):

> Rule 9(b) serves to give defendants adequate notice to allow them to defend against the charge and to deter the filing of complaints "as a pretext for the discovery of unknown wrongs," to protect professionals from the harm that comes from being subject to fraud charges, and to "prohibit [ ] plaintiff[s] from unilaterally imposing upon the court, the parties and society enormous social and economic costs absent some factual basis." *Semegen v. Weidner*, 780 F.2d 727, 731 (9th Cir. 1985). Because the same policy considerations apply to Section 11 claims sounding in fraud, we hold that persons making such

> claims must state with particularity the circumstances constituting the alleged fraud.

In re Stac Electronics Sec. Litig., 89 F.3d at 1405, App. 12a.

The court reaffirmed its decision by unanimously denying Petitioners' petition for rehearing and suggestion for rehearing *en banc*. *See id.* at 1401, App. 2a; *see also* App. 154a-155a.

REASONS FOR DENYING THE WRIT

I. SUMMARY OF ARGUMENT

This Court should refuse to grant review of this decision for two reasons:

First, nothing in the Ninth Circuit's holding conflicts with a decision of another court of appeals or of this Court.

Second, the decision raises no important federal question requiring this Court's review. Petitioners' Section 11 and Section 10(b) allegations failed, not because the Ninth Circuit adopted the wrong rule, but because the Prospectus disclosed the allegedly omitted facts in ways that rendered the Prospectus's statements not misleading, or because defendants were not required to disclose the purported omissions in the first instance. Even if, *arguendo*, the Ninth Circuit's application of Rule 9(b) and the "bespeaks caution" doctrine was wrong, that finding has no application beyond the parties to this case.

II. THE NINTH CIRCUIT'S DECISION TO APPLY RULE 9(b) TO SECTION 11 CLAIMS SOUNDING IN FRAUD DOES NOT WARRANT REVIEW BY THIS COURT

The Ninth Circuit's Rule 9(b) holding was not essential to its decision; the Section 11 claims fail even without Rule 9(b). Both the district court and the court of appeals held that Petitioners failed to allege a material misrepresentation in the Prospectus because the Prospectus "fairly overflow[ed]" with "specific and detailed" warnings on the very points that Petitioners allege were undisclosed. Because that conclusion turns on the unique allegations and disclosures in this case, the Ninth Circuit's decision has no widespread application, and presents no legal issue deserving review by this Court.

To the extent the Ninth Circuit held that Petitioner's Section 11 claims also failed under the particularity requirements of Rule 9(b), that decision does not warrant review by this Court because it is entirely consistent with the decisions of other courts of appeals, and raises no important federal question.

A. There Is No Conflict On This Issue Among The Courts Of Appeals Or With This Court's Decision In *Leatherman*

Petitioners mischaracterize the law on whether Rule 9(b) applies to Section 11 claims sounding in fraud. Contrary to Petitioners' claim, Petition ("Pet.") at 10, there is no conflict among the courts of appeals on this issue. Nor is there a conflict between any court of appeals' decision

and this Court's decision in *Leatherman v. Tarrant County Narcotics Intelligence & Coordination Unit*, 507 U.S. 163 (1993).

Four other circuits have directly addressed the issue – the First, Third, Fifth and Seventh – and all unanimously agree with the Ninth Circuit that, while a plaintiff need not plead fraud to state a claim under Section 11, once the plaintiff does so, Rule 9(b) applies.[3] *See Shaw v. Digital Equipment Corp.*, 82 F.3d 1194, 1223 (1st Cir. 1996) ("[D]espite the minimal pleading requirements of Sections 11 and 12(2), a complaint asserting violations of those statutes may yet 'sound[ ] in fraud,' " and Rule 9(b) would apply); *Melder v. Morris*, 27 F.3d 1097, 1100 n.6 (5th Cir. 1994) ("When 1933 Securities Act claims are grounded in fraud rather than negligence as they clearly are here, Rule 9(b) applies."); *Shapiro v. UJB Fin. Corp.*, 964 F.2d 272, 287-89 (3d Cir. 1992), *cert. denied*, 506 U.S. 934 (1992) (where complaint is devoid of allegations that defendants acted negligently in violating Section 11, and instead "brims with references to defendants' intentional

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[3] Although the Second Circuit has not directly addressed the issue, it has affirmed without explanation a lower court decision holding that Rule 9(b) applies to claims under Section 12(2) of the Securities Act of 1933 that sound in fraud. *Moran v. Kidder Peabody & Co.*, 609 F. Supp. 661, 666 (S.D.N.Y. 1985), *aff'd*, 788 F.2d 3 (2d Cir. 1986) (Rule 9(b) applies to claims under Section 12(2) "to the extent that such claims 'sound[] in fraud, a conclusion which may be assumed if the alleged misstatements are those generally referred to earlier in the complaint'."); *see also Sheppard v. TCW/DW Term Trust 2000*, 938 F. Supp. 171, 179 n.6 (S.D.N.Y. 1996) (quoting *Moran*, and holding that Rule 9(b) applies to claims under Sections 11, 12(2) and 15 of the 1933 Securities Act to the extent they sound in fraud).

and reckless misrepresentation," the claim is grounded in fraud and Rule 9(b) applies); *cf. Sears v. Likens*, 912 F.2d 889, 892-93 (7th Cir. 1990) (applying Rule 9(b) to § 12(2) claim).[4]

Nevertheless, Petitioners, by misdescribing several district court opinions, repeatedly and misleadingly claim there is "disarray" among the "lower courts." *See* Pet. at 10 & n.4; *see also* Pet. at 15 n.9. But disagreements among some district courts are not a basis for certiorari. *See* Supreme Court Rule 10(a) (certiorari may be based on "conflict with the decision of another United States court of appeals").

More fundamentally, Petitioners' district court cases are inapposite. None involved Section 11 claims "sounding in fraud," and several suggest that had such claims been at issue, Rule 9(b) would have applied. *See, e.g., In re AnnTaylor Stores Sec. Litig.*, 807 F. Supp 990, 1003 (S.D.N.Y. 1992) ("Since plaintiffs disavow any claim of fraud or mismanagement in [their Section 11 claim], it need not comply with Rule 9(b)."); *In re Lilco Sec. Litig.*, 625 F.

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[4] Numerous district courts have reached the same conclusion. *See, e.g., Picard Chemical Inc. Profit Sharing Plan v. Perrigo*, 940 F. Supp. 1101, 1115 (W.D. Mich. 1996); *Degulis v. LXR Biotechnology, Inc.*, 928 F. Supp. 1301, 1310 (S.D.N.Y. 1996); *Neubauer v. Eva-Health USA, Inc.*, 158 F.R.D. 281, 283 n.1 (S.D.N.Y. 1994); *Lucia v. Prospect Street High Income Portfolio, Inc.*, 769 F. Supp. 410, 416 (D. Mass. 1991), *aff'd*, 36 F.3d 170 (1st Cir. 1994); *In re Chambers Development Sec. Litig.*, 848 F. Supp. 602, 624 (W.D. Pa. 1994); *Haft v. Eastland Financial Corp.*, 755 F. Supp. 1123, 1132-33 (D.R.I. 1991); *Hershey v. MNC Financial, Inc.*, 774 F. Supp. 367, 375-76 (D. Md. 1991); *Competitive Associates, Inc. v. Fire Fly Enterprise, Inc.*, 59 F.R.D. 336, 337 (S.D.N.Y. 1972).

Supp. 1500, 1502 (E.D.N.Y. 1986) ("the Court does not find that these [Section 11] claims . . . incorporate allegations of fraud"); *Schneider v. Traweek*, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,507 at 97,662 (C.D. Cal. 1990) (Rule 9(b) inapplicable because Section 11 claims at issue sounded in negligence, not fraud); *Husted v. Amrep Corp.*, 429 F. Supp. 298, 310 (S.D.N.Y. 1977) (noting that even if Rule 9(b) did apply to violation of Section 1709(a) of the Interstate Land Sales Act modeled after Section 11, its requirements were met by the allegations of complaint); *Schoenfeld v. Giant Stores Corp.*, 62 F.R.D. 348, 350-51 (S.D.N.Y. 1974) (distinguishing its decision not to apply 9(b) from cases in which the "nub of the allegations . . . sounded in fraud"). Accordingly, there is no conflict in decisions worthy of this Court's attention.

Nor does the Ninth Circuit's decision conflict with this Court's decision in *Leatherman*. *See* Pet. at 10, 14-15. *Leatherman* simply limits Rule 9(b) to the two instances specifically mentioned in the Federal Rules: namely, averments of fraud and mistake. *Leatherman*, 507 U.S. at 168. Here, the Ninth Circuit found that Petitioners alleged a Section 11 claim in name only, and that, in fact, Petitioners' averments of fraud so permeated the Complaint that their Section 11 claim inevitably "sounded in fraud" as well. Applying Rule 9(b) to a Section 11 claim based on averments of fraud is entirely consistent with *Leatherman*.

B. The Decision Was Reasonable And Does Not Raise An Important Federal Question

The Ninth Circuit's application of Rule 9(b) to the Section 11 claim in this case makes sense. Rule 9(b)

requires particularity in "*all* averments of fraud or mistake," Fed. R. Civ. P. 9(b) (emphasis added), not just those brought under Section 10(b). Its heightened pleading standards serve an important screening function against bogus fraud claims, whatever form they may take: they ensure that defendants will have fair notice of plaintiff's claim; prevent complaints from being used "as a pretext for the discovery of unknown wrongs"; and safeguard reputations – especially those of outside professionals whose reputations in their fields of expertise are most sensitive to slander – from the harm that comes from charges of fraud.[5] *See Semegen v. Weidner*, 780 F.2d 727, 731 (9th Cir. 1985); *accord Acito v. IMCERA Group, Inc.*, 47 F.3d 47, 52 (2d Cir. 1995).

Petitioners argue that Rule 9(b) should not apply because their Section 11 claim specifically excluded allegations of fraud. Pet. at 18. The Ninth Circuit, however, found Petitioners' attempts to segregate their claims "nominal" and "unconvincing" because the gravamen of the complaint was obviously fraud: the Section 11 claim lacked any independent basis and instead adopted

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[5] The *in terrorem* effect of nuisance actions in complex security fraud cases like this one is well-recognized. "[T]o the extent [discovery] permits a plaintiff with a largely groundless claim to simply take up the time of a number of other people, with the right to do so representing an *in terrorem* increment of the settlement value, rather than a reasonably founded hope that the process will reveal evidence, it is a social cost rather than a benefit." *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 741 (1975); *accord In re Time Warner Inc. Sec. Litig.*, 9 F.3d 259, 263 (2d Cir. 1993), *cert. denied*, ___ U.S. ___, 114 S. Ct. 1397 (1994); *DiLeo v. Ernst & Young*, 901 F.2d 624, 627 (7th Cir.), *cert. denied*, 498 U.S. 941 (1990).

wholesale the allegations of securities fraud elsewhere in the Complaint.[6] *In re Stac Electronics Sec. Litig.*, 89 F.3d at 1405 n.2, App. 11a n.2; *cf. Shapiro v. UJB Fin. Corp.*, 964 F.2d at 288 (applying Rule 9(b) to Section 11 claim where complaint was devoid of allegations that defendants

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[6] Despite Petitioners' "nominal" disclaimer, the specific factual allegations incorporated by reference into Petitioners' Section 11 count clearly averred that defendants acted fraudulently by misrepresenting and omitting to represent certain material information knowingly, recklessly and/or intentionally. *See* App. 169a and 119a (Stac defendants undertook the IPO to allow them to cash out before adverse facts became public); 172a, 178a-179a, 201a, 203a (Stac's insiders undertook to artificially inflate Stac's reported results and conceal softening demand for its products by offering customers special terms); 188a, 194a (defendants "knew or recklessly disregarded" the misrepresentations and omissions from the Prospectus and that facts were being concealed from the public); 200a (Stac's insiders commenced licensing negotiations with Microsoft to delay Microsoft's announcement of a competing product); 230a (Underwriters agreed to issue very positive reports on Stac in exchange for being selected as the underwriters for the IPO); 241a (Stac's insiders manipulated revenues and earnings).

Moreover, Petitioners' Section 11 claim in the First Amended Complaint was explicitly grounded in fraud. *Anderson v. Clow*, [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 97,990, App. 134a (emphasis in original) ("[T]he [First Amended] Complaint alleges not just that there were untrue statements or misleading omissions. It alleges that the Prospectus was *fraudulent*."). These former allegations are admissible against Petitioners as admissions. *See American Title Ins. Co. v. Lacelaw Corp.*, 861 F.2d 224, 226 (9th Cir. 1988); *Sunkyong Int'l, Inc. v. Anderson Land & Livestock Co.*, 828 F.2d 1245, 1249 n.3 (8th Cir. 1987).

acted negligently, but was replete, as here, with references to defendants' intentional and reckless misrepresentations). Despite its label, therefore, it was essentially a fraud claim, and entitled defendants to the protections of Rule 9(b). *See id.* at 1404-05 & n.2, App. 11a-12a & n.2; *accord Melder v. Morris*, 27 F.3d at 1100 n.6; *Shapiro v. UJB Fin. Corp.*, 964 F.2d at 288. To have held otherwise would have elevated form over substance. As one court explained:

> The mere fact that plaintiffs need not prove scienter to recover under §§ 11 and 12(2) does not mean that §§ 11 and 12(2) claims can never "sound in fraud." On the contrary, a plaintiff may allege [under those sections] a scheme which, if proven, would constitute fraud. That is precisely what plaintiffs have done here. The gist of their claims is that [defendant] embarked upon a scheme fraudulently to overstate its financial health. . . . While they have invoked §§ 11 and 12(2) as legal bases for these claims, the gravamen of their case is fraud. . . . [¶] [Rule 9(b)'s] application should depend on the substance of a plaintiff's allegations, not upon the guise in which he portrays them.

Hershey v. MNC Financial, Inc., 774 F. Supp. 367, 375-76 (D. Md. 1991); *accord Shaw v. Digital Equipment Corp.*, 82 F.3d at 1223 ("It is the allegation of fraud, not the 'title' of the claim that brings the policy concerns [underlying Rule 9(b)] . . . to the forefront."); *cf. Shapiro v. Miami Oil Producers, Inc.*, 84 F.R.D. 234, 236 (D. Mass. 1979) (Rule 9(b) extends to averments of fraud or mistake, "whatever may be the theory of legal duty – statutory, tort, contractual, or fiduciary").

Petitioners cannot avoid this conclusion by contending that they are not required to "show" any basis for their Section 11 claim because it rests on "strict liability." *See* Pet. at 18 n.14. Rather, as the court of appeals held, they must "*adequately* . . . allege a material misrepresentation or omission." *In re Stac Electronics Sec. Litig.*, 89 F.3d at 1403, App. 8a; *In re VeriFone Sec. Litig.*, 11 F.3d 865, 868-69 (9th Cir. 1993). Here, the court found they did not. Whether or not that decision was correct, the sufficiency of Petitioners' attempts to state a claim under Section 11 is a narrow issue, turning on the nature of the allegations peculiar to this case.[7] It is not an important issue of law warranting certiorari.

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[7] The need for particularity was especially important here because the Underwriters' alleged involvement in the scheme to defraud investors was inherently implausible. *See Tuchman v. DSC Communications Corp.*, 14 F.3d 1061, 1068-69 (5th Cir. 1994) (plaintiffs face a "more stringent [pleading] standard" when fraud claims are based on an irrational theory); *DiLeo v. Ernst & Young*, 901 F.2d at 629 (same). The institutional investors Petitioners claim the Underwriters so willingly deceived are the lifeblood of their business. When a company is brought public, the brokerage firms acting as the company's underwriters purchase the entire stock offering at a discount and sell it, principally to institutional investors, who are the firms' regular customers, and who trust them to place their money into sound investments. A brokerage firm risks losing these clients and damaging its reputation in the market by recommending an investment in a company that later experiences an unexpected reversal in earnings. Accordingly, an analyst or brokerage firm would not knowingly market a bad stock to its customers, or perpetuate the deception by distributing misleading research reports after the offering, merely to earn the limited fees the firm realizes from the offering itself. *See In re VeriFone Sec. Litig.*,

Petitioners' contention that the opinion below will lead to a multiplicity of suits is also meritless. Pet. at 16-21. Nothing in the Ninth Circuit's ruling or the decision of any other court of appeals prohibits plaintiffs from joining Section 11 and Section 10(b) claims in one complaint. Indeed, courts have had no difficulty in construing such claims separately when they are properly pleaded. *See, e.g., Degulis v. LXR Biotechnology, Inc.*, 928 F. Supp. at 1310 (noting that the Section 11 and 12(2) claims against one defendant surely sound in fraud, while those against another group of defendants "seem more clearly to sound in negligence" and are not subject to Rule 9(b)); *In re Chambers Development Sec. Litig.*, 848 F. Supp. at 624 (specific paragraphs incorporated into Section 11 claim support the inference that it is predicated on negligence, not fraud). Here, Petitioners simply failed to segregate their Section 11 and 10(b) claims. Whether or not the court construed their allegations correctly, its conclusion raises no important question for this Court. The interpretation of a particular complaint is too fact-intensive an inquiry to have widespread application.

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784 F. Supp. 1471, 1481 (N.D. Cal. 1992), *aff'd*, 11 F.3d 865 (9th Cir. 1993) ("the professional analyst has more interest in making the most accurate prediction possible, because the analyst's reputation and livelihood depend solely on the analyst's ability to be correct"); *see also Melder v. Morris*, 27 F.3d at 1104 n.10 ("to think that the underwriters would put their valuable professional reputation at risk to ostensibly 'profit' from two relatively minor securities offerings presents an inference of irrationality we refuse to indulge").

III. THE NINTH CIRCUIT'S APPLICATION OF THE "BESPEAKS CAUTION" DOCTRINE DOES NOT WARRANT REVIEW BY THIS COURT

Petitioners also try to manufacture an issue for review concerning the "bespeaks caution" doctrine. They repeatedly claim that the court of appeals improperly "immunized" the defendants and foreclosed liability solely because the Prospectus contained "boilerplate" warnings that "there can be no assurance" that certain events or conditions (such as the adequacy of Stac's reserves) would turn out as anticipated. *See* Pet. at 25; *see also* Pet. at 21. That is not what the Ninth Circuit held.

Although the numerous disclosures and warnings in the Prospectus, including the "no assurance" disclaimers, were found to be adequate in this instance, nothing in the Ninth Circuit's opinion holds or even implies that dismissal is *always* warranted because of the presence of "no assurance" language. To the contrary, the opinion emphasizes that the statements must be analyzed "in context," *In re Stac Electronics Sec. Litig.*, 89 F.3d at 1408, (App. 21a), and that dismissal is *precluded* unless the "challenged documents include *enough* cautionary language or risk disclosure that reasonable minds could not disagree that the challenged statements were not misleading." *Id.*, 89 F.3d at 1408, App. 20a (emphasis in original). As the court explained:

> [T]he 'bespeaks caution' doctrine has developed to address situations in which optimistic projections are coupled with cautionary language . . . affecting the reasonableness of

> reliance on and the materiality of those projections. To put it another way, the 'bespeaks caution' doctrine reflects the unremarkable proposition that statements must be analyzed in context.

Id., App. 21a, *quoting In re Worlds of Wonder Sec. Litig.*, 35 F.3d 1407, 1414 (9th Cir. 1994), *cert. denied*, ___ U.S. ___, 116 S. Ct. 185 (1995).[8]

The court then applied the doctrine to the *forward-looking* statements in *this* case, including information in the Prospectus about the adequacy of Stac's reserves:

> Analyzing the quoted statements in context leads to the inexorable conclusion that investors were specifically and adequately cautioned about the relevant risks. Insofar as Stac's alleged misstatements can be viewed as "optimistic projections," they are more than adequately covered by the bespeaks caution doctrine.

Id., App. 22a.

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[8] The principle is consistent with this Court's statement in *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083 (1991):

> [w]hile a misleading statement will not always lose its deceptive edge simply by joinder with others that are true, the true statements may discredit the other one so obviously that the risk of real deception drops to nil. . . . [Therefore,] publishing accurate facts . . . can render a misleading proposition too unimportant to ground liability.

Id. at 1097. *See In re Worlds of Wonder Sec. Litig.*, 35 F.3d at 1415; *see also Harden v. Raffensperger, Hughes & Co., Inc.*, 65 F.3d 1392, 1405 (7th Cir. 1995).

As to the alleged misstatements and omissions that were necessarily historical in nature, the court, without applying the doctrine, concluded that the Prospectus as a whole "adequately disclosed" the information Petitioners alleged defendants had concealed.[9] *In re Stac Electronics Sec. Litig.*, 89 F.3d at 1409, App. 23a. Accordingly, the Prospectus was not misleading as a matter of law.

There is nothing remarkable, or reviewworthy, in the court's holding or analysis, and they are indisputably correct. Virtually every circuit has embraced the "bespeaks caution" doctrine and articulated substantially the same rule. *See, e.g., Shaw v. Digital Equipment Corp.*, 82 F.3d at 1213-14; *Harden v. Raffensperger, Hughes & Co.*, 65 F.3d at 1404; *Rubenstein v. Collins*, 20 F.3d 160, 166-68 (5th Cir. 1994); *In re Donald J. Trump Casino Sec. Litig.*, 7 F.3d 357, 371-73 (3d Cir. 1993), *cert. denied*, 510 U.S. 1178 (1994); *Moorhead v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 949 F.2d 243, 245-46 (8th Cir. 1991); *Sinay v. Lamson & Sessions Co.*, 948 F.2d 1037, 1040 (6th Cir. 1991); *I. Meyer Pincus & Assocs. v. Oppenheimer & Co.*, 936 F.2d 759, 763 (2d Cir. 1991); *see also Gasner v. Board of Supervisors*, No. 96-1010, 1996 WL 741803, *5-*8 (4th Cir., Dec. 31, 1996); *Saltzberg v. TM Sterling/Austin Associates, Ltd.*, 45 F.3d 399, 400 (11th Cir. 1995).

None of these courts held that a particular disclaimer or disclosure is always sufficient. To the contrary, it is

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[9] Thus, Petitioners' statement that the court erroneously applied the "bespeaks caution" doctrine to historical statements in the Prospectus, *see* Pet. at 23, misreads the opinion below.

well-settled (even among the authorities on which Petitioners rely) that whether cautionary language cures otherwise misleading statements can be determined only on a case-by-case basis. *See, e.g., U.S. v. Morris*, 80 F.3d 1151, 1167 (7th Cir. 1996) ("[T]he effect of cautionary language on an otherwise misleading statement must be assessed on a case-by-case basis"), *cert. denied*, ___ U.S. ___, 117 S. Ct. 181 (1996); *Harden v. Raffensperger, Hughes & Co., Inc.*, 65 F.3d at 1404 ("Courts apply this narrow fact-intensive defense on a case-by-case basis[.]"); *Rubinstein v. Collins*, 20 F.3d at 167-68 (same); *Krim v. BancTexas Group, Inc.*, 989 F.2d 1435, 1448-49 (5th Cir. 1993) (whether cautionary language and disclosures of adverse facts affects materiality is determined by analyzing particular facts of the case); *In re Donald J. Trump Casino Sec. Litig.*, 7 F.3d at 371-73 (application of the doctrine depends on the specific text of communications at issue and the nature of the cautionary language).

Accordingly, there is no conflict among the courts of appeals as to whether "bespeaks caution" applies to such disclaimers, as Petitioners contend. *See* Pet. at 26. Nor does any of Petitioners' cases support their claim that "no assurance" language is always insufficient as a matter of law. *See* Pet. at 23. *See, e.g., U.S. v. Morris*, 80 F.3d at 1167; *Harden v. Raffensperger, Hughes & Co., Inc.*, 65 F.3d at 1404; *Rubinstein v. Collins*, 20 F.3d at 167-68 & n.27 (all holding that the adequacy of warnings and disclosures must be determined on a case-by-case basis).

Moreover, Petitioners' cases are inapposite because they involve the adequacy of "no assurance" disclaimers relating to statements of historical *fact* that were knowingly false or had no reasonable basis when made, not to

forward-looking statements. In *U.S. v. Morris*, for example, the defendant bank received an in-depth review of its loan portfolio (the "SA") recommending an additional $9.3 million in loan loss reserves *before* it issued an offering circular stating it believed reserves were "adequate." *Id.* at 1155. In light of the bank's actual knowledge at the time of the offering, a disclaimer in the circular that there could be "no assurance" that additional loan loss reserves would not be necessary in the future was plainly inadequate and misleading.[10] *Id.* at 1168. Similarly, in *Harden v. Raffensperger, Hughes & Co.*, 65 F.3d at 1406, the "no assurance" disclaimer concerning the outcome of an application for federal insurance was insufficient because the company allegedly knew, *before* it issued the registration statement, that there was no possibility that the application would be approved. In *Rubinstein v. Collins*, 20 F.3d 160 at 168-169, the "no assurance" disclaimer concerning the size and value of a recently-discovered natural gas

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[10] The *Morris* court made this clear in its opinion, but Petitioners deleted that portion of the court's explanation in the block quote on page 24 of their petition. The court actually said:

> The language relied upon by defendants here does nothing more than to apprise potential investors that actual losses in the portfolio cannot now be predicted with absolute certainty. . . . The uncertain nature of predicting future loan losses does not neutralize the misleading character of this statement *when the government proved to the jury's satisfaction that management's "present analysis" (the SA) actually recommended the doubling of existing reserves.* The qualifying statements thus do not exhaust the capacity of the adequacy statement to mislead.

U.S. v. Morris, 80 F.3d at 1168 (emphasis added).

reserve was inadequate because the company allegedly knew at the time of the prospectus of adverse test results that suggested the reserves were much smaller than originally thought.[11]

In sum, this case raises no important question warranting this Court's review. Petitioners' Complaint failed, not because the Ninth Circuit adopted the wrong rule, but because their allegations were insufficient in the context of the myriad disclosures made in this *particular* Prospectus. Petitioners' real complaint is not with the Ninth Circuit's *articulation* of the doctrine, which was correct, but with its *application* to this case. The application of settled law to facts, however, does not provide a basis for certiorari, even if the court below applied the law incorrectly. The court's decision here, based on the correct rule of law, and the unique facts before it, will have no impact beyond the immediate parties to this

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[11] Petitioners' corresponding contention (again, to suggest that a conflict exists) that other courts routinely "accept" no assurance disclaimers, Pet. at 21-22 & n.16, is also false. None of the authorities petitioners cite in support of that proposition relied solely on a "no assurance" disclaimer to determine liability. Instead, each court based its holding on a variety of disclosures and warnings, including "no assurance" disclaimers, that it construed as a whole in the context of the offering materials at issue. *See, e.g., Olkey v. Hyperion 1999 Term Trust, Inc.*, 98 F.3d 2, 6 (2d Cir. 1996); *Glassman v. Computervision Corp.*, 90 F.3d 617, 635-36 & n.27 (1st Cir. 1996); *Romani v. Shearson Lehman Hutton*, 929 F.2d 875, 879 (1st Cir. 1991); *Luce v. Edelstein*, 802 F.2d 49, 56 (2d Cir. 1986); *In re Computervision Sec. Litig.*, 869 F. Supp. 56, 60-61 & n.3 (D. Mass. 1994); *Stevens v. Equidyne Extractive Industries 1980*, 694 F. Supp. 1057, 1063-64 (S.D.N.Y. 1988).

litigation. Thus, this case raises no question requiring this Court's review.

CONCLUSION

There is no reason for this Court to review this case, which presents neither a conflict in decisions nor any important federal question. The petition should be denied.

Respectfully submitted,

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